India Banking 2010
Towards a High-performing Sector

McKinsey&Company

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Preface

India is well positioned to become the fourth-largest economy in the world by 2025. GDP growth rates of 7-8 per cent a year will be sustainable going forward if key enabling factors have been put in place. One of the enablers of robust economic growth is a banking sector that is able to adequately and efficiently meet the needs of a growing economy.

It is in this context that we have approached "India Banking 2010". Our firm belief is that the shape of the banking sector in 2010 will be the result of a strong interplay between the decisions taken by policy makers and actions of bank managements. We have outlined the sets of choices before policy makers and bank managements and the three possible scenarios that could result from these different choices.

To place the impact of these scenarios in perspective, we have attempted to quantify the differences in impact on the economy. Our conclusion is that the costs of inaction or insufficient action will be high. In one scenario, the sector could have a value add to GDP ratio of almost 8 per cent, a loan to GDP ratio of over 100 per cent and provide over 1.5 million jobs. Alternatively, it could have a value add to GDP ratio of only 3 per cent, with the loan to GDP ratio increasing marginally to 45 per cent, and employ about 1.2 million people.

This white paper is a synthesis of the research and analyses conducted by McKinsey & Company over the last few years, both in India and across the world. In our writing of this document, we are grateful to several eminent leaders in the Indian banking sector who took the time to share their perspectives with us on this topic. They include Mr. A. K. Purwar, Mr. Ashok Kini, Mr. T.S. Bhattacharya, Mr. K.V. Kamath, Ms. Kalpana Morparia, Mr. Deepak Parekh, Dr. P.J. Nayak, Mr. Uday Kotak, Mr. H.N. Sinor and Dr. Rakesh Mohan amongst others. While we have benefited tremendously from their criticism and advice, all perspectives, views and omissions in this document are attributable only to the authors.

We are hopeful that this document, although by no means a prescription, will help facilitate discussion and debate as both policy makers and banks progress towards the common objective of creating a world-class banking sector in India.

Executive Summary

The last decade has seen many positive developments in the Indian banking sector. The policy makers, which comprise the Reserve Bank of India (RBI), Ministry of Finance and related government and financial sector regulatory entities, have made several notable efforts to improve regulation in the sector. The sector now compares favourably with banking sectors in the region on metrics like growth, profitability and non-performing assets (NPAs). A few banks have established an outstanding track record of innovation, growth and value creation. This is reflected in their market valuation. However, improved regulations, innovation, growth and value creation in the sector remain limited to a small part of it. The cost of banking intermediation in India is higher and bank penetration is far lower than in other markets. India's banking industry must strengthen itself significantly if it has to support the modern and vibrant economy which India aspires to be. While the onus for this change lies mainly with bank managements, an enabling policy and regulatory framework will also be critical to their success.

The failure to respond to changing market realities has stunted the development of the financial sector in many developing countries. A weak banking structure has been unable to fuel continued growth, which has harmed the long-term health of their economies. In this "white paper", we emphasise the need to act both decisively and quickly to build an enabling, rather than a limiting, banking sector in India.

GOOD PERFORMANCE, QUESTIONABLE HEALTH

Indian banks have compared favourably on growth, asset quality and profitability with other regional banks over the last few years. The banking index has grown at a compounded annual rate of over 51 per cent since April 2001 as compared to a 27 per cent growth in the market index for the same period. Policy makers have made some notable changes in policy and regulation to help strengthen the sector. These changes include strengthening prudential norms, enhancing the payments system and integrating regulations between commercial and co-operative banks.

However, the cost of intermediation remains high and bank penetration is limited to only a few customer segments and geographies. While bank lending has been a significant driver of GDP growth and employment, periodic instances of the "failure" of some weak banks have often threatened the stability of the system. Structural weaknesses such as a fragmented industry structure, restrictions on capital availability and deployment, lack of institutional support infrastructure, restrictive labour laws, weak corporate governance and ineffective regulations beyond Scheduled Commercial Banks (SCBs), unless addressed, could seriously weaken the health of the sector. Further, the inability of bank managements (with some notable exceptions) to improve capital allocation, increase the productivity of their service platforms and improve the performance ethic in their organisations could seriously affect future performance.

OPPORTUNITIES AND CHALLENGES FOR PLAYERS

The bar for what it means to be a successful player in the sector has been raised. Four challenges must be addressed before success can be achieved. First, the market is seeing discontinuous growth driven by new products and services that include opportunities in credit cards, consumer finance and wealth management on the retail side, and in fee-based income and investment banking on the wholesale banking side. These require new skills in sales & marketing, credit and operations. Second, banks will no longer enjoy windfall treasury gains that the decade-long secular decline in interest rates provided. This will expose the weaker banks. Third, with increased interest in India, competition from foreign banks will only intensify. Fourth, given the demographic shifts resulting from changes in age profile and household income, consumers will increasingly demand enhanced institutional capabilities and service levels from banks.

ONE OF THREE SCENARIOS WILL PLAY OUT BY 2010

The interplay between policy and regulatory interventions and management strategies will determine the performance of Indian banking over the next few years. Legislative actions will shape the regulatory stance through six key elements: industry structure and sector consolidation; freedom to deploy capital; regulatory coverage; corporate governance; labour reforms and human capital development; and support for creating industry utilities and service bureaus. Management success will be determined on three fronts: fundamentally upgrading organisational capability to stay in tune with the changing market; adopting value-creating M&A as an avenue for growth; and continually innovating to develop new business models to access untapped opportunities.

Through these scenarios, we paint a picture of the events and outcomes that will be the consequence of the actions of policy makers and bank managements. These actions will have dramatically different outcomes; the costs of inaction or insufficient action will be high. Specifically, at one extreme, the sector could account for over 7.7 per cent of GDP with over Rs.. 7,500 billion in market cap, while at the other it could account for just 3.3 per cent of GDP with a market cap of Rs. 2,400 billion. Banking sector intermediation, as measured by total loans as a percentage of GDP, could grow marginally from its current levels of ~30 per cent to ~45 per cent or grow significantly to over 100 per cent of GDP. In all of this, the sector could generate employment to the tune of 1.5 million compared to 0.9 million today. Availability of capital would be a key factor — the banking sector will require as much as Rs. 600 billion (US$ 14 billion) in capital to fund growth in advances, non-performing loan (NPL) write offs and investments in IT and human capital upgradation to reach the high-performing scenario. Three scenarios can be defined to characterise these outcomes:

- **High performance:** In this scenario, policy makers intervene only to the extent required to ensure system stability and protection of consumer interests, leaving managements free to drive far-reaching changes. Changes in regulations and bank capabilities reduce intermediation costs leading to increased growth, innovation and productivity. Banking becomes an even greater driver of GDP growth and employment and large sections of the population gain access to quality banking products. Management is able to overhaul bank organisational structures, focus on industry consolidation and transform the banks into industry shapers.

In this scenario we witness consolidation within public sector banks (PSBs) and within private sector banks. Foreign banks begin to be active in M&A, buying out some old private and newer private banks. Some M&A activity also begins to take place between private and public sector banks.

As a result, foreign and new private banks grow at rates of 50 per cent, while PSBs improve their growth rate to 15 per cent. The share of the private sector banks (including through mergers with PSBs) increases to 35 per cent and that of foreign banks increases to 20 per cent of total sector assets. The share of banking sector value add in GDP increases to over 7.7 per cent, from current levels of 2.5 per cent. Funding this dramatic growth will require as much as Rs. 600 billion in capital over the next few years.

- **Evolution:** Policy makers adopt a pro-market stance but are cautious in liberalising the industry. As a result of this, some constraints still exist. Processes to create highly efficient organisations have been initiated but most banks are still not best-in-class operators. Thus, while the sector emerges as an important driver of the economy and wealth in 2010, it has still not come of age in comparison to developed markets. Significant changes are still required in policy and regulation and in capability-building measures, especially by public sector and old private sector banks.

  In this scenario, M&A activity is driven primarily by new private banks, which take over some old private banks and also merge among themselves. As a result, growth of these banks increases to 35 per cent. Foreign banks also grow faster at 30 per cent due to a relaxation of some regulations. The share of private sector banks increases to 30 per cent of total sector assets, from current levels of 18 per cent, while that of foreign banks increases to over 12 per cent of total assets. The share of banking sector value add to GDP increases to over 4.7 per cent.

- **Stagnation:** In this scenario, policy makers intervene to set restrictive conditions and management is unable to execute the changes needed to enhance returns to shareholders and provide quality products and services to customers. As a result, growth and productivity levels are low and the banking sector is unable to support a fast-growing economy. This scenario sees limited consolidation in the sector and most banks remain sub-scale. New private sector banks continue on their growth trajectory of 25 per cent. There is a slowdown in PSB and old private sector bank growth. The share of foreign banks remains at 7 per cent of total assets. Banking sector value add, meanwhile, is only 3.3 per cent of GDP.

NEED TO CREATE A MARKET-DRIVEN BANKING SECTOR WITH ADEQUATE FOCUS ON SOCIAL DEVELOPMENT

The term “policy makers” used in this document, as mentioned earlier, refers to the Ministry of Finance and the RBI and includes the other relevant government and regulatory entities for the banking sector. We believe a co-ordinated effort between the various entities is required to enable positive action. This will spur on the performance of the sector. The policy makers need to make co-ordinated efforts on six fronts:

- Help shape a superior industry structure in a phased manner through “managed consolidation” and by enabling capital availability. This would create 3-4 global sized banks controlling 35-45 per cent of the market in India; 6-8 national banks controlling 20-25 per cent of the market; 4-6 foreign banks with 15-20 per cent share in the market, and the rest being specialist players (geographical or product/segment focused).

- Focus strongly on "social development" by moving away from universal directed norms to an explicit incentive-driven framework by introducing credit guarantees and market subsidies to encourage leading public sector, private and foreign players to leverage technology to innovate and profitably provide banking services to lower income and rural markets.
- Create a unified regulator, distinct from the central bank of the country, in a phased manner to overcome supervisory difficulties and reduce compliance costs.
- Improve corporate governance primarily by increasing board independence and accountability.
- Accelerate the creation of world class supporting infrastructure (e.g., payments, asset reconstruction companies (ARCs), credit bureaus, back-office utilities) to help the banking sector focus on core activities.
- Enable labour reforms, focusing on enriching human capital, to help public sector and old private banks become competitive.

NEED FOR DECISIVE ACTION BY BANK MANAGEMENTS

Management imperatives will differ by bank. However, there will be common themes across classes of banks:

- PSBs need to fundamentally strengthen institutional skill levels especially in sales and marketing, service operations, risk management and the overall organisational performance ethic. The last, i.e., strengthening human capital will be the single biggest challenge.
- Old private sector banks also have the need to fundamentally strengthen skill levels. However, even more imperative is their need to examine their participation in the Indian banking sector and their ability to remain independent in the light of the discontinuities in the sector.
- New private banks could reach the next level of their growth in the Indian banking sector by continuing to innovate and develop differentiated business models to profitably serve segments like the rural/low income and affluent/HNI segments; actively adopting acquisitions as a means to grow and reaching the next level of performance in their service platforms. Attracting, developing and retaining more leadership capacity would be key to achieving this and would pose the biggest challenge.
- Foreign banks committed to making a play in India will need to adopt alternative approaches to win the "race for the customer" and build a value-creating customer franchise in advance of regulations potentially opening up post 2009. At the same time, they should stay in the game for potential acquisition opportunities as and when they appear in the near term. Maintaining a fundamentally long-term value-creation mindset will be their greatest challenge.

The extent to which Indian policy makers and bank managements develop and execute such a clear and complementary agenda to tackle emerging discontinuities will lay the foundations for a high-performing sector in 2010.