Banking on Growth

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With the Indian economy growing at a brisk clip of nine-plus per cent per annum, there is growing global and domestic interest in the nation's banking industry. Experts have also projected that India would emerge as the third largest banking hub in the world by 2040. **Rajeshwari Adappa Thakur** writes about the buoyant sector

Thanks to the upswing in the Indian economy, a younger population, the low penetration of banking services in the country and a host of other factors, the Indian banking sector today stands on the threshold of exponential growth. According to a PricewaterhouseCoopers (PwC) report, India may well be the third largest banking hub in the world by 2040.

Attracted by the idea of servicing a fast growing economy and the promise of a liberalised scenario in 2009, a host of foreign banks have either applied to or are in talks with India's banking regulator, the Reserve Bank of India (RBI), for licences. The Royal Bank of Scotland, Royal Bank of Canada, Credit Suisse and Switzerland's UBS AG are among the many banks reported to have evinced interest in being part of the Indian banking sector.

"India today offers one of the fastest growing markets for financial products and services across the globe," says Sanjay Nayar, CEO, Citibank. "I don't think any banking and financial services company seeking growth can afford to ignore India."

Further, within the E7 group (seven emerging market economies which include China, India, Brazil, Russia, Indonesia, Mexico and Turkey) "India is likely to be the fastest growing of the E7 economies in the long run, according to the report," points out Jairaj Purandare, executive director, PwC in India.

Given the huge potential, corporate houses like the Tatas and Reliance - Anil Dhirubhai Ambani Group, besides several others, are said to be interested in having a slice of the banking pie. The Tata group recently acquired a less than 5 per cent stake in the Development Credit Bank, a publicly listed bank, and is interested in starting a bank.

Anil Ambani, chairman of Reliance Capital, says the company might either start or acquire a bank. Ambani describes the Indian growth story as "perhaps the greatest economic growth story ever to unfold anywhere in the world".

The GE group of the US, which has forayed into the Indian financial sector, is also keenly monitoring the situation here. Says Vishal Pandit, president and CEO, GE Money India: "We are watching closely the RBI's evaluation of banks and non-bank finance companies, and will

CLOSE WATCH: Vishal Pandit

adapt our business plan in India to be aligned with the rules and regulations of local authorities."

Of course, banking being a regulated sector the world over, getting licences to set up even a branch is difficult let alone a licence to set up a bank. This is a problem not just for foreign banks in India but also for Indian banks planning to expand abroad.

Instead, many foreign banks choose to set up representative (rep) offices in India. Italy's Monte Dei Paschi Di Siena and Banche Popolari Unite S.c.r.l, Switzerland's Zurcher Kantonalbank, Spain's BBVA and the Commonwealth Bank of Australia, are among the banks that are reported to have shown interest in setting up rep offices in India. These offices help foreign banks to get an idea about local business environment.

Existing banks also wish to expand their businesses and are hoping to get permission to set up more branches. "On a long-term basis, Indian retail banking business definitely looks attractive as it is a huge under-penetrated banking market," says Eric Dhoste, chief executive and group country head, India, Societe Generale.

The entry of new banks is unlikely to result in overcrowding as the Indian

MAJOR UPHEAVALS IN THE OFFING

The banking sector will grow significantly faster than GDP in the 'E7' emerging economies of China, India, Brazil, Russia, Indonesia, Mexico and Turkey, according to new projections by PricewaterhouseCoopers. Total profits from domestic banking in the E7 could be around half those in the G7 (US, Japan, Germany, UK, France, Italy and Canada) by 2025 and larger than in the G7 much before 2050.

In a previous report, 'The World in 2050', published in March 2006, PwC economists predicted that by the year 2050, the 'E7' economies will have outstripped the current G7 by around 25 per cent when comparing GDP using market exchange rates and around 75 per cent when using purchasing power parity (PPP) exchange rates.

A new report, 'Banking in 2050: How big will the emerging markets get?', examines the possible changes in the scale of the banking sector between now and 2050 and highlights the pace of change, while providing some measure of the size of the opportunity and challenge for banks. The projections are based on an analysis of developments in G7 and E7 banking markets since the 1950s, which highlights the tendency of the banking sector to grow faster than GDP as economies develop.

The new projections for the banking market, using projected market exchange rates, suggest that total domestic credit in China could overtake the UK and Germany by 2010, Japan by 2025 and the US before 2050. India could also rise from relatively low levels today to emerge as the third largest domestic banking market in the world by 2040 and, in the long run, could grow faster than China.

The strategic implications of the rise of the E7 banking markets include strong growth in M&A activity both within the E7 countries (due to consolidation of often fragmented banking sectors at present) and across borders. Restructuring of the E7 economies should also create major opportunities for private equity firms.

Leading E7 banks will also expand outwards and become major competitors in the global 'war for talent', a trend that is already underway with Russian, Chinese and Indian banks attracting staff with experience of G7 institutions. As the E7 banks leverage the knowledge of these staff, their competitiveness in both domestic and global markets will increase.

"Interestingly, this analysis suggests that India is likely to be the fastest growing of the E7 economies in the long run," notes Jairaj Purandare, executive director, Pricewaterhouse Coopers. "The model also suggests that while China will continue to grow faster than India over the next decade, after that, Chinese growth will be held back by its rapidly ageing population and diminishing returns to its investment-led strategy. In contrast, India has a much younger population with faster-growing labour forces."

The E7 banking markets will become ever more important in the global banking sector and institutions that do not develop strong positions in these markets will find it difficult to maintain the same growth rates of assets and profits as those that do. Continued high levels of deal activity in the E7 markets is expected, albeit with the normal short-to-medium-term cyclical variations over time. M&A will encompass consolidation activity 'in-market' as local banks acquire one another, foreign banks enter the E7 markets, and banks from the E7 expand internationally through acquisitions.

The banking world in 2050, predicts the report, "will look radically different from the one we see today, with the E7 economies becoming at least as important as the G7. This reflects both faster projected GDP growth in the E7 and the systematic tendency of banking sectors to grow faster than GDP as economies develop. The E7 markets are relatively high risk, but our analysis suggests the potential to mitigate these risks through making long-term investments in a broad portfolio of emerging banking markets."

RETAIL BANKING: THE NEW BUZZWORD

Progress has a new address and that is India. The economic growth coupled with the robust gains in stock markets has brought with it prosperity and wealth in the hands of Indians. The number of millionaires in India has crossed the 100,000-mark. Salaries in India have witnessed a 13-14 per cent growth, higher than that seen in China and other South East Asian countries.

"This means there is more money in the hands of the people that needs to be managed well," says Pralay Mondal, country head, retails assets and credit cards, HDFC Bank. This increase in wealth is fuelling the growth of the retail banking sector.

"The increasing size of the Indian middle class, rising income levels and growing aspirations are key factors for retail financial service growth universally," explains Vishal Pandit, president and CEO, GE Money India. "Currently retail finance is growing at about 20 per cent and we expect similar growth rates to sustain over next 5-10 years."

In the fight for the share-of-the-wallet, the consumer ends up being treated as king, which is a new experience for a vast majority of Indians, who had been ignored for decades. "Across most of the retail banking product segments – be it home loans, or credit cards, or personal loans – the penetration levels in India are still in the low single digits as a percentage of GDP. Hence the potential for growth is huge," adds Neeraj Swaroop, CEO – India, Standard Chartered Bank.

With access to loans – for not just first, but even second homes, cars, education, consumer durables, holidays, investments – having become easier, consumers are lapping up the attention and the loans. "On the consumer side, consumer finance, cards, investment services are businesses in which we believe there is tremendous underlying potential to grow substantially more," notes Sanjay Nayar, CEO, Citibank.

Here banks have to compete with aggressive NBFCs. "Banks have a more universal approach to the market place. Their more diversified funding capabilities, broader activities and product range help them compete efficiently against NBFCs," adds Eric Dhoste, chief executive and group country head, India, Societe Generale.

The boom in the financial services market has led to the creation of vast armies of sales persons called direct sales agents (DSAs) for marketing the varied products.

Another strategy used by some banks is to tap into their own large base of depositors who are offered multiple products depending on their needs. "This helps to lower acquisition costs, lower default rates and higher deposits being held in banks by the customer," says Mondal.

Banks are now targeting the rural consumers too. "About 40% of our new branches are located in the B and C category towns,'' says Mr Mondal. Banks are also offering micro-finance in order to fulfill their social obligations.

If retail banking is a buzzword in India today, the reason is not far to see. After all, margins in retail banking are higher than corporate banking and the growth too is faster.

Several banks that were not very active in retail banking are now eyeing this sector. "We are looking at the best ways to develop a presence in this market, bearing in mind that a retail business can't give profits unless you are able to scale it up," says Dhoste.

Indian customers are getting more demanding. "The demands of customers today are global and need to be addressed real-time," says Nayar. The risk-averse Indian, who saved for the future is metamorphosing into a demanding consumer who believes in living for today, is more comfortable with debt and is more financially savvy. Just the person retail bankers had been looking for.

RADICAL CHANGES: Jairaj Purandare

banking sector has tremendous potential for growth. According to the PwC report, total domestic credit in India was around $400 billion compared to China's $ 2.8 trillion.

But the new banks will have to compete with existing banks including nationalised ones, private sector banks, foreign banks, smaller institutions including co-operative banks and in some areas with non-banking finance companies too. The Indian banking system has come a long way since 1786 when the first bank was set up in India. In the pre-Independence days, initially banks were set up as private institutions with mostly European shareholders. Post-independence, most of the banks were nationalised in 1969.

In the 1990s, following economic reforms, the banking sector was also liberalised. The entry of private banks and increasing competition resulted in nationalised banks becoming more efficient and turning aggressive in the market place. The introduction of automated teller machines (ATMs), phone banking and internet banking by most banks has bid adieu to the serpentine queues seen earlier.

STREAMLINED SERVICE: Growing competition has brought about major changes in the banking industry.

The changing economic climate vindicates the decision of foreign banks who decided to stay on in India despite the challenges. "India has always been a priority market for us," remarks Neeraj Swaroop, CEO – India, Standard Chartered Bank, incidentally the first foreign bank to cross $300 million in profits. "At a time when other foreign banks were exiting India, we bought Grindlays in 2000 to become the largest international bank in the country. It is only recently that other international banks are waking up to the India story."

Global banks who are yet to script an India story, clearly believe that better late than never. Foreign banks like Singapore's United Overseas Bank Ltd, Banca Popolare di Vicenza of Italy, Landesbank Hessen-Thuringen Girozentrale of Germany and Svenska Handelsbanken AB, Sweden are also said to be interested in doing business in India.

This interest in India is not without good reason. "An under-penetrated market and the opportunity to service a large, young, working age population, which will create and therefore need help to manage wealth, emerging Indian multinationals with global horizons, entrepreneurs with surplus wealth and limited investment options makes India an extremely attractive market," explains Nayar of Citibank.

STAYING ON: Neeraj Swaroop

The fast growing economy (spread across urban and rural areas) has witnessed eight straight quarters of eight-plus-per cent GDP growth (with 2006-07 at 9.4 per cent) and 20-plus-per cent export growth. The stable political situation and the fact that successive governments have not rolled back reforms, shows that the process is irreversible.

Credit Suisse has forecast a growth of 10 per cent in GDP growth in the current fiscal. "We are excited about the growth opportunities and investment potential offered by the country," remarks Paul Calello, CEO of Credit Suisse Investment Bank

Interestingly, the under-developed banking sector of India is likely to gallop at a faster rate than India's GDP. "The banking sector growth will be disproportionately faster due to the growth in domestic credit," explains Purandare.

Being a credit-averse nation (which is changing now) India has a very low debt penetration. "The debt to income ratio is around five per cent in India compared to 27 per cent in South East Asia and higher than 50 per cent in developed markets," says Pandit of GE Money. "Hence no global player can afford to ignore the Indian market."

While other emerging markets also offer similar opportunities, India's size is its trump card. "Size matters," notes Pralay Mondal, country head, retail assets and credit cards, HDFC Bank. "Add to that the low penetration (of formal banking services) in India, almost three times lower than other developed countries. Growth is a given."

The Indian economy presents varied opportunities for banks. A younger population and rapid economic growth has boosted consumer banking.

The traditional banking business that caters to the needs of corporates is also growing at a fast pace. Today India Inc's global aspirations are being fuelled by foreign bankers, who help them raise funds (either equity or debt) or finance their acquisition plans. For instance, Citibank has reportedly helped in financing up to $15 billion of acquisitions by Indian corporates overseas. The small and medium enterprises (SMEs) segment too is seeing a resurgence as they go global

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GLOBAL ASPIRATIONS: Foreign banks are funding overseas acquitisions

OLD AND NEW PLAYERS

State Bank of India (SBI), a nationalised bank, is the largest bank in the country. The other major players are Allahabad Bank, Punjab National Bank, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, and Indian Bank, institutions that were set up in the early 1900s as private banks but were nationalised subsequently.

Leading private sector banks like ICICI Bank and HDFC Bank leveraged technology to provide more efficient services, thus stealing a march over the older, nationalised banks. There exist many smaller banks such as co-operative banks that operate at the local level.

Citibank and Standard Chartered Bank are among the biggest foreign banks in India; others include HSBC and Deutsche Bank. "Though we are a registered British bank, we are as much an Indian bank as any other with 150 years of history in this country, says Neeraj Swaroop, CEO – India, Standard Chartered Bank. "Even now, we employ over 17,000 people in India - more than in any other country." Other than the pure banking operations, many foreign banks also have other interests. For instance, Citi Financial is the largest NBFC in the country, with a network of 450 branches in 180 cities while French Bank Societe Generale, apart from banking activities, also has interests in a BPO SG Global Solution Centre in Bangalore and a car fleet management company ALD which has a presence in Mumbai, Delhi, Bangalore and Hyderabad.

Eric Dhoste, chief executive and group country head, India, Societe Generale, says that the group employs more than 1,000 employees in India across all activities.

There are many NBFCs in India that are hoping to metamorphose into banks, just as Kotak Mahindra Finance, formerly an NBFC, converted into Kotak Bank. GE Money has used the partnership route to grow its business in India. It is number two in the credit cards business and serves 3.3 million card customers with joint venture partner, State Bank of India.

TRUMP CARD: Pralay Mondal

in technology, markets and funds. "Their banking needs are getting more complex as they scale up," notes Swaroop of Standard Chartered. "Banks are also seeing increased action in transaction based businesses such as bill discounting."

A fast developing country like India also needs good infrastructure to sustain economic growth, leading to opportunities in the areas of infrastructure / project finance. Incidentally, the government too is keen to ensure that credit growth moves into the productive side, that is, industry and the rural economy.

Thanks to the RBI, the Indian banking sector remains on track. When inflation threatened to derail the growth story, it enforced strict norms that helped to rein in inflation. The level of non performing assets (NPA) in Indian banks too is in keeping with internationally acceptable levels and is lower than in some South East Asian countries.

In anticipation of the growth in the coming years, existing players in India are drawing up major expansion plans. The Tatas are said to have lined up a massive investment of over a billion dollars over the next three to four years through a new company, Tata Capital. Anil Ambani wants Reliance Capital, one of

SCALING UP: Eric Dhoste

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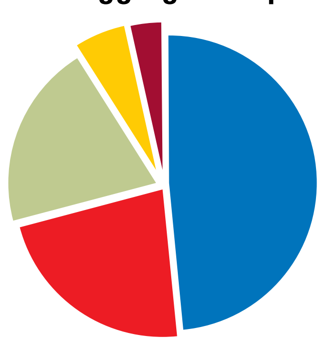
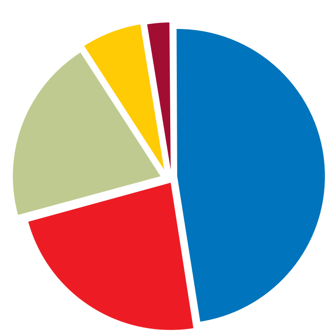
GROWING AUTOMATION: Banks are expanding their ATM networks

Share of aggregate deposits



- Nationalised Banks – 48.4 % of aggregate deposits
- SBI and associates – 22.3%
- Other scheduled commercial banks – 20.6%
- Foreign banks – 5.6%
- Regional rural banks – 3.2%

Share of Gross Bank Credit



- Nationalised Banks – 47.5 %
- SBI and associates – 23.2%
- Other scheduled commercial banks – 20.3%
- Foreign banks – 6.6%
- Regional rural banks – 2.5%

Source: RBI (as of March 31, 2007)

GROWTH POTENTIAL: Sanjay Nayar

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GLOBAL EXPANSION: Private banks like ICICI are expanding their overseas network

the fastest growing financial sector companies, to be among the top three financial services companies, including banks, in the country. It plans to increase its employee strength from current 11,000 to 50,000 over the next two years.

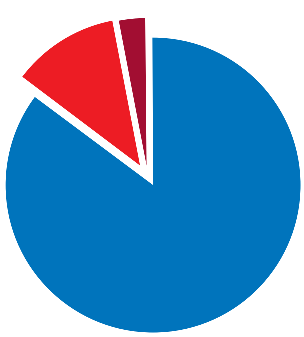
Due to regulatory restrictions, foreign banks can only grow organically today. "We can only grow organically, and we are focusing on that," remarks Swaroop. "After 2009, if regulatory changes allow, we are open to looking at inorganic opportunities."

Banks and other financial sector players are also increasing their portfolio of services to tap the new emerging opportunities such as wealth management and mortgage products. "All our major business units are constantly looking at best ways to add value and penetrate the Indian market," says Dhoste of Societe Generale. Much depends on the extent of liberalisation in the sector. The banking industry is divided over whether the sector will be opened to greater competition in the year 2009. "However, it is felt that eventually, if not in 2009, but a few years down the line, the RBI will open the sector, at least partially. It is only a matter of time," says an optimistic banker. Purandare of PwC points out that "if the banking sector is not opened up, then GDP will also suffer." Also, greater competition can lead to better price discovery, deeper penetration and introduction of global best practices.

The resilience of the Indian banking system was first visible when the country came out unscathed from the East Asian crisis. The gradual pace of reforms in the country have only resulted in making the banking sector one of the most sound and robust in the world. Barring social or political volatility, most industry officials are confident that the sector will continue to do well.

The banking industry has been a partner in the nation's progress. India's tryst with growth is likely to continue in the future as a robust banking sector provides the critical support necessary for stable and sustained growth.

Total assets (as of end-March 2006)



- Commercial Banks (84) – 81%
- Co-operative Banks (3000) – 11%
- Regional Rural Banks (133) – 3%

Source: RBI (as of March 31, 2007)

BANKING SECTOR HIGHLIGHTS

- In India, there are 84 commercial banks, which account for about 81 per cent (total assets) of the financial sector at end-March 2006; over 3000 cooperative banks, which account for 11 per cent; and 133 Regional Rural Banks, which account for 3 per cent.
- The capital adequacy ratio has increased to 12.4 per cent for scheduled commercial banks as at end March 2006, which is much above the international norm.
- Commercial banks' net profits remained at 0.9 per cent of total assets during 2004-05 and 2005-06, up from 0.16 per cent in 1995-96.
- The ratio of NPLs to total loans of scheduled commercial banks, which was as high as 15.7 per cent at end-March 1997, declined steadily to 3.3 per cent by end-March 2006.
- The net non-performing assets declined to 1.2 per cent of net advances during 2005-06 from 2.0 per cent in 2004-05. According to the preliminary financial results available for most of the banks for the year 2006-07, the financial soundness has improved further.