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The total assets of Indian banks, which are regulated by the Reserve Bank of India (RBI) and the Ministry of Finance (MoF), were pegged at Rs 82,99,220 crore (US$ 1564.8 billion) during FY12. Further, the revenues of Indian banks grew almost four-fold from US$ 11.8 billion to US$ 46.9 billion over the decade spanning 2001-10.

The prognosis for Indian banks looks positive with the domestic credit as a percentage of the GDP having grown substantially over the last decade. This was primarily because the conventional policies of the RBI have worked well to limit India’s exposure to the sub-prime crisis of 2008, which stemmed when regulators eased their grip on financial corporations, thereby leading to the high risk leveraging of assets. Though the government is working hard to control inflation rates, the industry expects full implementation of Basel III (currently banks in India are following Basel II) norms by March 2018. This will require a considerable credit raise, especially for public sector banks; however, an assessment of the assets of private sector banks such as ICICI and Kotak Mahindra reveals that they already have sufficient capital, and will sail through this change.

This report analyses the current state of the banking industry, and its future growth potential. It provides perspectives on how various factors, such as the financial crisis of 2008, the Eurozone crisis, the implementation of Basel III, the Union Budget and other government initiatives are expected to influence the industry. The report also highlights certain key challenges, such as controlling non performing assets and financial inclusion, before moving on to talk about the growth prospects of the industry in coming years.

1. *A comparison of public sector and private sector banks in India*
2. *Indian Banks’ Association*
3. *LiveMint*
1. CURRENT STATUS AND DEVELOPMENT OF THE INDIAN BANKING SECTOR

The Indian economy’s liberalisation in the early 1990s has resulted in the conception of various private sector banks. This has sparked a boom in the country’s banking sector in the past two decades. The revenue of Indian banks grew four-fold from US$ 11.8 billion to US$ 46.9 billion, whereas the profit after tax rose nearly nine-fold from US$ 1.4 billion to US$ 12 billion over 2001-10. This growth was driven primarily by two factors. First, the influx of Foreign Direct Investment (FDI) of up to 74 per cent with certain restrictions. Second, the conservative policies of the Reserve Bank of India (RBI), which have shielded Indian banks from recession and global economic turmoil. Figure 1.1 and 1.2 compares the country’s Banking Index (Bankex) with the Sensex. The Bankex is an index tracking the performance of important banking sector stocks, and has grown at a compounded annual growth rate (CAGR) of approximately 20 per cent over 2003-12. The Figure below shows that the Bankex and the Sensex have had similar growth trends over the past decade.

![Figure 1.1: Performance of Bankex over 2002-12](image)

Source: Bombay Stock Exchange

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5 McKinsey Report – Transform to Outperform
6 Bombay Stock Exchange
The high CAGR exhibited by India’s Bankex demonstrates the industry’s resilience to recession and economic instability. This resilience primarily stems from two factors. First, the highly regulated Indian banking sector restricts exposure to high risk assets and excessive leveraging. Second, Indian economy’s overall growth rate has been much higher than other economies worldwide.

However, the recent crisis in the eurozone is likely to affect the Indian economy and in particular the country’s banking sector. The RBI’s Financial Stability Report estimates the claim of European Banks on India at approximately 8.6 per cent of the country’s GDP, while some analysts estimate the figure to have reached 15 per cent of the GDP. Further, the recent implementation of the Basel III guidelines may also force European banks to deleverage significantly. Data from the International Monetary Fund (IMF) suggests that these banks will deleverage relatively.

Source: Bombay Stock Exchange

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up to US$ 2.6 trillion by the end of 2013 especially from the sale of securities and non-core assets. This will see the credit supply to businesses shrinking by 1.7 per cent⁸, thereby driving Indian companies to borrow from the Indian banks at a higher cost in times of inflation and in a period of depreciation in the value of rupee⁹. The non performing assets (NPAs) of banks were pegged at 2.9 per cent in the fourth quarter of 2011, and are expected to rise to 3.5 per cent by 2012¹⁰. All these factors might hamper the performance of the Indian banking sector. However, amongst positive initiatives taken by the government, the RBI mandated banks to maintain 70 per cent of the provision coverage ratio of their bad loans as on September 2010, thereby mitigating the effect of NPAs to a certain extent¹⁰. The NPAs of public, private and foreign banks in India are exhibited in Figure 2.

The solace for Indian banks, however, lies in the fact that India has shown a comparatively robust growth in its GDP over past years, which analysts closely correlate to the performance of the banking industry¹¹. The report forecasts that India’s GDP growth will take the size of the country’s banking sector, to the third largest in the world by 2025¹¹. Figure 3 shows the data from the Ministry of Finance that supports this.

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⁸ Financial Times – IMF sees EU banks deleveraging upto US$ 2.6 trillion
⁹ LiveMint – NPAs have bottomed out
¹⁰ The Economic Times – RBI relaxes norms for provisioning of bad loans
¹¹ Boston Consulting Group – Being Five Star in Productivity, Aug 2011
Figure 3 demonstrates that the growth of the banking sector in terms of percentage contribution to the GDP has remained mostly uniform over FY 06-10. The banking sector is currently growing at approximately the same rate as the country’s economy.

Another important parameter for assessing the performance of the banking industry is the domestic credit provided as a percentage of the GDP, as exhibited in Figure 4 below.

1.1 Competitive landscape and leading banks in India

Banking in India is moderately consolidated, with the top 10 players accounting for approximately 60 per cent of the total industry. The Indian banking sector is majorly dominated by public sector banks. Figure 5 describes the market shares of the leading players (based on total credit portfolio), along with the respective shares of government, private and foreign banks.
With the help of Figure 6, we assess the performance of India’s leading banks on key metrics, such as credit portfolio size, net interest margins (NIM) and non-performing assets (NPA) ratio.
The State Bank of India (SBI), Punjab National Bank (PNB) and Bank of Baroda (BoB) had the first, second and third largest credit portfolios, respectively. HDFC emerged as among the best performers with a strong NIM ratio and the lowest NPA ratio, whereas, ICICI (with the fourth largest credit portfolio) reported a high NPA ratio in 2011.

To address this problem of high NPAs, the Government introduced numerous measures through the Union Budget and other policy initiatives to strengthen the sector and raise capital. Some of these measures have been discussed in the subsequent sections.
2. WAY FORWARD – KEY DEVELOPMENTS AND AN ANALYSIS OF THE UNION BUDGET OF 2012–13

The overall prognosis of the Union Budget of 2012–13 was mostly positive. It focused primarily on infusing capital into the system to propagate future growth and enable the system to adopt the Basel III norms over the next five years. The following section highlights certain key points of the budget for the banking industry, and their associated implications.

2.1 What the Union Budget of 2012–13 offers the banking industry

For the banking industry as a whole, the Union Budget held three major announcements:

- First, the government suggested a proposed investment of Rs 15,888 crore (US$ 3 billion) for the capitalisation of public sector banks, regional and rural banks (RRBs), and other financial institutions, including the National Bank for Agriculture and Rural Development (NABARD). This move is expected to provide these institutions with equity and bring them a step closer to complying with the Basel III norms.

- Second, agricultural credit was increased from Rs 4,75,000 crore (US$ 89.6 billion) to Rs 5,75,000 crore (US$ 108.4 billion) over FY12 to FY13. The budget also proposed modifications in the Kissan Credit Card (KCC) scheme to make it a smart card that can be used at ATMs. This is expected to promote awareness in rural areas, and encourage better use of financial products among farmers. The government has also set up a credit refinance scheme for RRBs to give short term crop loans to small and marginal farmers.

- Third, the Swabhimaan scheme promoting financial inclusion was extended to North-East and hilly regions with a population of over 1,000, and other areas with a population of 2,000. Currently, approximately 73,000 habitations have been covered under the Swabhimaan Scheme.

The government has increased the provisions under the Rural Housing Fund by Rs 10,000 crore (US$ 1.9 billion) to Rs 40,000 crore (US$ 7.5 billion). It has also sanctioned the development of a central "Know Your Customer" (KYC) depository, to bring the structure of banking payments at par with the global standards. RRBs accounted for 29 per cent of NABARD’s total credit in 2010–11. Therefore, the government has proposed a Rs 10,000 crore (US$ 1.9 billion) investment in NABARD specifically for refinancing the RRBs.

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12 Major Announcements in the Union Budget 2012–13 for the Banking Sector
13 Deloitte – Union Budget 2012–13
14 Key Highlights from the Union Budget
15 DNB – Analysis of the Union Budget
These measures are expected to boost the credit growth in the Indian banks and enable credit flow to different sectors of the economy.\textsuperscript{15}

2.2 Other regulatory developments that impact the Indian banking sector

The RBI, which regulates other India banks, formulated several policies and initiatives that directly impacted the country’s banking sector over the last few years. Some of these initiatives are as follows:\textsuperscript{7}:

- **Deregulation of savings rates for banks in India\textsuperscript{16,17}**: In a move that enables banks to decide the interest rates they offer on savings accounts, the RBI has deregulated the savings bank deposit interest rates from an earlier norm of 4 per cent per annum to aid product and price innovation in the long run. This is expected to push up the interest rates in the short term, and especially on deposits of a high amount due to intense competition. Higher interest rates imply higher costs for banks, and are expected to affect their profitability. On the other hand, costs are expected to rise for large scale borrowers as a hike in interest rates might be accompanied with a projected rise in loan rates.

- **Provision Coverage Ratio (PCR) of 70 per cent mandatory for banks\textsuperscript{18}**: The mandatory directive to maintain a PCR of 70 per cent benefits all commercial banks. The current PCR can be used to minimise NPAs during economic downturn.

- **Basel III guidelines\textsuperscript{19,20}**: The RBI has planned the implementation of the Basel III norms, which would require a capital infusion of approximately US$ 60 billion over the next five years. These norms would require the systemically important banks to maintain a higher level of capital, at a time when the credit demand in the economy is rising. This might hamper the banking industry’s short term growth. However, Dr. Subbarao, the Governor of the Reserve Bank of India in 2012, commented that Basel III would make Indian banks stronger in the long run, thereby enabling them to invest in the real sectors of the economy.

- **Relaxation of branch authorisation policy for tier II cities\textsuperscript{21}**: Under the relaxation of Branch Authorisation Policy, the domestic banks do not need the RBI approval to set up service offices, central processing centres and administrative offices in the tier II cities, with a population ranging between

\textsuperscript{16} The Economic Times – Deregulation of savings bank deposit interest rates
\textsuperscript{17} Business Standard – Will savings rate deregulation help banks?
\textsuperscript{18} Economic Times – RBI relaxes norms for provisioning bad loans
\textsuperscript{19} The Hindu – Basel III
\textsuperscript{20} The Economic Times – Basel III
\textsuperscript{21} The Economic Times – Banks can open braches in tier II cities without RBI nod
50,000 to 99,999. Further, a similar relaxation to expand into tier III to tier VI cities already exists. The policy will spread the organised banking to the remote areas of the country, and aid financial inclusion.

- **Relaxation of mobile payment guidelines**: With the increasing popularity of mobile banking, the RBI removed the cap of Rs. 50,000 (US$ 942.7) for transactions through mobile phones. This relaxation allowed banks to assess the involved risk, and place their own limits while granting customers with mobile banking facilities. In a statement, the RBI commented that the Interbank Mobile Payment Service (IMPS), which was developed and operated by the National Payment Corporation of India (NPCI), also enabled real time fund transfer among different banks.

- **Issue of financial guidelines for new bank licenses**: The RBI, deviating from its traditional policy of granting licenses to only a few private institutions, is now issuing new bank licenses to all entities that satisfy the eligibility criteria. This move is expected to encourage healthy competition and promote financial inclusion in the banking industry.

- **Subsidiary route for foreign banks**: The RBI is encouraging foreign players entering the Indian banking industry to conduct business through wholly owned subsidiaries. Further, it is promoting existing important foreign players to incorporate themselves as wholly owned subsidiaries of foreign parent companies. This move is expected to benefit foreign players by allowing them to expand their consumer base to semi urban areas.

These measures were taken to address some key factors affecting the growth of the Indian banking industry. A few of these factors have been highlighted in the sections below –

- **Expansion into rural markets**: Expanding operations to rural markets has been a concern for private and foreign banks as it prevents financial inclusion. Some larger players have managed to establish their presence in rural markets either through mergers and acquisitions, or acquiring associates. For instance, ICICI Bank merged with Bank of Rajasthan to expand its consumer base in rural markets.

- **Increased Non Performing Assets**: Though Indian banks have been performing well financially, there has been an increase in the levels of NPAs present in the banking industry. To reduce NPAs, the RBI has proposed
measures, such as developing a mechanism to flag warnings and classifying NPA accounts on the basis of segments.

- **Intensifying competition due to homogeneous products**\(^{25,26}\): Most Indian banks offer homogeneous services, which result in high competition in the industry on finer points, such as loan rates and interest rates. Many new entrants, especially non-banking financial corporations (NBFC), are expected to enter the industry in the coming years due to the new Banking License Guidelines of the RBI. High competition will benefit the industry in the long run by driving all banks (especially public sector banks) to improve their performance.

The factors need to be carefully analysed in order to take corrective measures such as policies, initiatives and remedial business strategies in the future. The Indian banking sector has high growth potential, primarily due to proposed high growth of the country’s economy, as compared to other developed nations. Therefore, it is also essential to analyse the growth drivers of the industry, discussed below.

**Growth in the Indian economy**

The performance of the Indian economy is one of the strongest drivers for the banking industry’s growth and vice versa (also shown in Figure 1), and the average GDP growth of 8.1 per cent expected over 2011–16 will facilitate the expansion of the banking sector\(^{27}\). The government policies bringing in monetary stability will also benefit and shield the industry from global economic or political turmoil. Figure 6 compares the performance of the top banking stocks, which exhibits a similar growth trend. However, a keen observation reveals that the banking sector has outperformed the market 2010 onwards.

A boost in the banking industry is also expected from the rising per capita income in India, which along with a growth in the earning population of the country will lead to a higher number of people utilising banking services\(^{27}\). The per capita income growth is expected to be a major driver, as the Indian population primarily comprises of conservative spenders who invest in property and other necessities. Higher disposable income will increase the retail credit, with consumers investing in a wide range of products\(^{28}\).

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\(^{25}\) Growth Drivers for the Indian Banking Industry

\(^{26}\) IBEF – Report on banking, November 2011

\(^{27}\) Growth drivers in the Indian banking industry
Financial Inclusion and technological transformation in banking

A World Bank Survey conducted in 2011 revealed that only 35 per cent of all adults in India had a bank account with a formal banking institution, while this figure stood at 21 per cent in the poorest income quantile. This represents a massive opening that financial institutions in the country can leverage upon for future growth. Further, the policies of the Reserve Bank have prioritised financial inclusion, presenting an opportunity that might not manifest itself again. The Indian government has advised banks to open at least one branch in villages with a population of more than 2,000, and also cover the peripheral villages. Banks are also required to formulate a board approved Financial Inclusion Plan (FIP), the implementation of which will be monitored by the RBI.

The Indian government can bring in financial inclusion by setting up ATMs and providing mobile/online banking facilities. Further, experts suggest that the number of ATMs need to increase by 5 times to reach 160,000-190,000 in the coming decade. The mobile banking channel in India is also untapped, with close to 900 million mobile connections, and only 400 million bank accounts. With mobile connections expected to grow to 1,150 million by 2020, mobile banking is a key growth prospect and an important channel for financial inclusion. Figure 7 gives a perspective on the transaction costs of various banking channels and highlights the cost saving that can be achieved through mobile, online and ATM banking.

![Figure 7](image)

**Source:** KPMG Report – Technology Enabled Transformation in Banking

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29 World Bank – Financial Inclusion Survey
30 Reserve Bank of India
31 FICCI–BCG Report – Indian Banking 2020
Human Resource Development

Eliminating the human capital related challenges, especially in state owned banks (forming the largest share of the country’s banking industry), will be a major growth driver for the industry in the future. A McKinsey report suggests that banks in India need to recruit employees with both core and specialist skills, and control attrition especially at the junior levels. Non private Indian banks will greatly benefit from productivity improvements, such as a re-engineering of the institutions knowledge processes, better use of technology and building industry level utilities.\(^{33}\)

\(^{33}\) McKinsey report – Human Capital is the Key to Unlocking a Golden Decade in Indian Banking
3. CONCLUSION

The economic growth of the country is an apt indicator for the growth of the banking sector. The Indian economy is projected to grow at a rate of 5-6 per cent\textsuperscript{34} and the country’s banking industry is expected to reflect this growth. The onus for this lies in the capabilities of the Reserve Bank of India as an able central regulatory authority, whose policies have shielded Indian banks from excessive leveraging and making high risk investments.

The competitive scenario in India is strong, with the landscape primarily dominated by government banks. Market entry at the country level is expected to be tough for new players due to the moderately consolidated nature of the industry and extremely high competition. The key challenges for the industry are to reduce NPAs, increase financial inclusion and raise capital for the Basel III compliance.

The overall impact of suggested changes in the 2012–13 Union Budget is expected to be positive. These changes are mostly focussed on financial inclusion through expansion into rural areas, and bringing stability by boosting credit growth\textsuperscript{35}. This may enable banks to meet the increasing demand for credit in the economy and comply with the Basel III norms.

According to the top consulting firms, the growth of Indian banks, especially in the public sector, can be optimised through increasing productivity and efficient human resource management. Banks need to hire employees with both core and specialist skills, while simultaneously working to control attrition. Further, banks need to optimise the time and cost of performing non consumer activities with the help of special tools and revamping existing knowledge processes. Sustained government support and a careful re-evaluation of existing business strategies can help the Indian banks achieve strong growth.

Sustained government support and a careful re-evaluation of existing business strategies can set the stage for Indian banks to become bigger and stronger, thereby setting the stage for expansions into a global consumer base.

\textbf{Note:} Conversion rate used is US$ 1 = Rs 53.0358

\textsuperscript{34} Business Standard – Finance Minister to lower GDP projection in mid-year economic review

\textsuperscript{35} D&B analysis of the 2012-13 Union Budget
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