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BANKING SECTOR IN INDIA

India Sector Notes

April 2014

Indian banking sector at a glance

$1.4 trillion

Banking Deposits

41%

Unbanked Population in India

42.8

India's Banking Penetration Score

$1.8 trillion

Total Banking Assets

27.5%

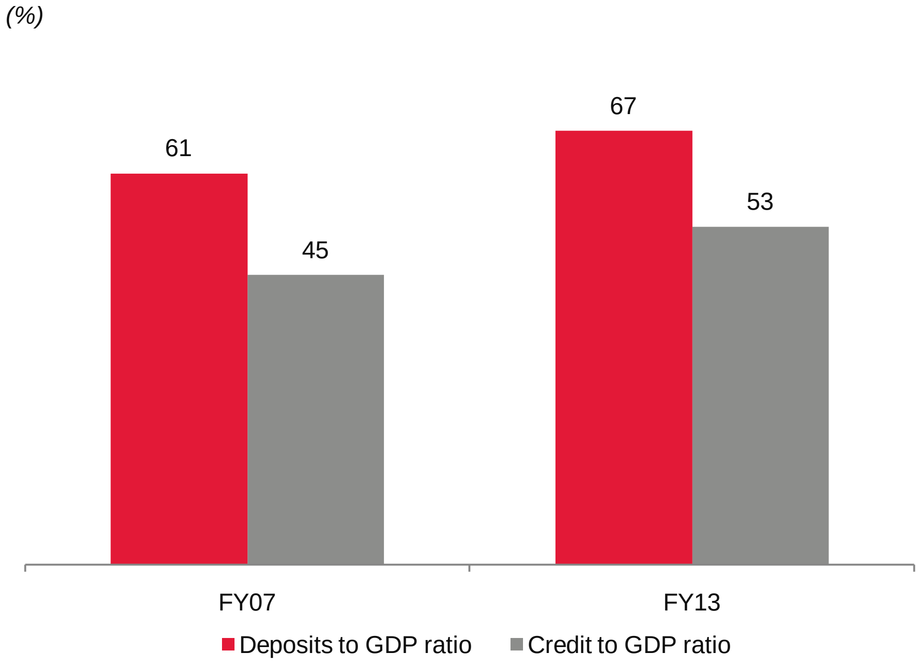
Banking Sector's Share in Total BFSI Employment

157

Total Number of Schedule Commercial Banks in India

India’s banking sector plays a key role in economic growth and employment

CONTRIBUTION TO GDP



- Aggregate deposits of all Scheduled Commercial Banks (SCBs), as a percentage of GDP increased from 61% in FY07 to 67% in FY13, driven by increasing demand from retail customers.
- Credit to GDP increased from 45% in FY07 to 53% in FY13 indicating the improved lending of SCBs to various industries, which has enhanced trade and economic development.

CONTRIBUTION TO EMPLOYMENT

(in ‘000s)

Industry segments	Total employment FY13 (in ‘000s)	% of total
Banking*	1,100–1,200	25–30%
Insurance*	200–300	4–5%
NBFC*	25–30	0–1%
Mutual Funds*	15–20	0–1%
Financial Intermediaries	2,500–3,000	65–70%
Total BFSI	**4,000–5,000**	**100%**

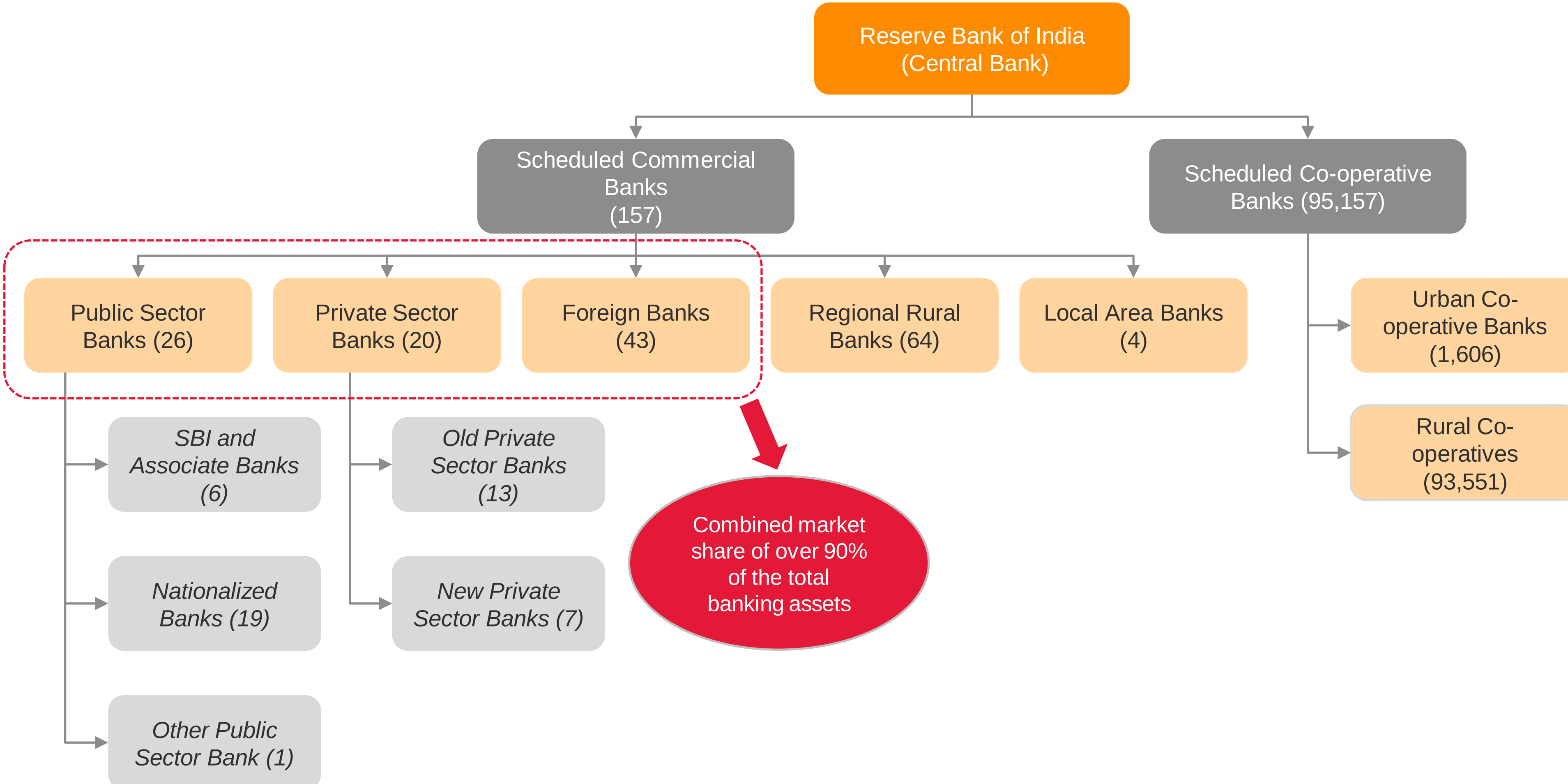
Note: **On-rolls employee*

- Within the Banking, Financial services and Insurance (BFSI) sector, financial intermediaries such as DSA’s, insurance agents, mutual fund advisors, etc. account for the largest share (65–70%) of employment.
- Banking stands second in terms of employment (average share of 28%). The banking sector is projected to create up to 2 million new jobs in the next 5-10 years, driven by issuance of new licenses and efforts to expand financial services into rural areas.

Source: *Reserve Bank of India (RBI), National Skill Development Corporation (NSDC)*

India's banking industry is classified into scheduled commercial banks and scheduled co-operative banks with the Reserve Bank of India as the central bank

BANKING STRUCTURE IN INDIA



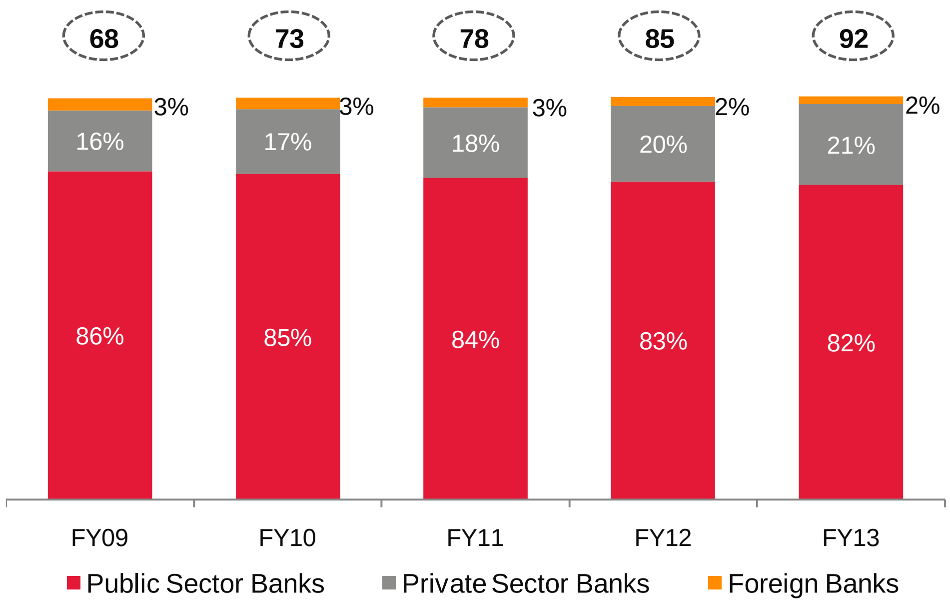
Source: *RBI*

Note: *Figures in brackets indicate the number of institutions as on March 31, 2013*

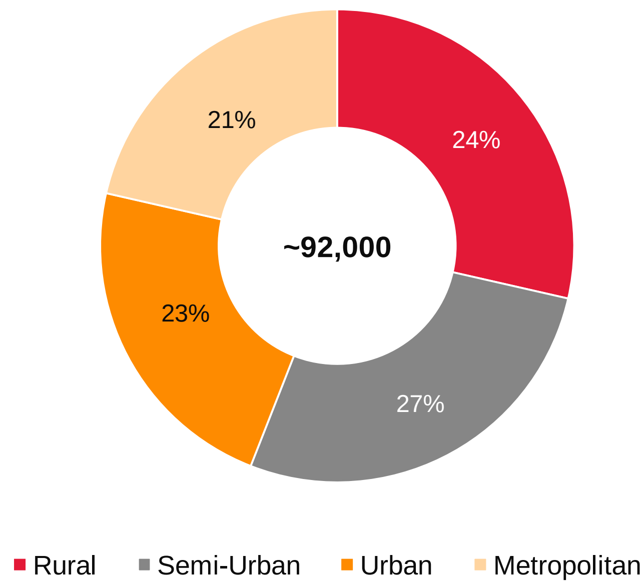
Number of branches has grown at a robust pace led by private sector banks

NUMBER OF BRANCHES – BY BANK TYPE

(in ‘000s)



REGIONAL DISTRIBUTION OF SCB BRANCHES (FY13)



- The Indian banking system has been continuously expanding with the number of SCB branches increasing at a CAGR of 7.8% during FY09 to FY13. The private sector banks have been expanding at a faster rate (7.1% CAGR in number of branches) compared to public sector banks (-1.1%) and foreign banks (-10%).
- Of the total number of new branches opened in FY13, 24% were opened in unbanked centers. The proportion of branches opened in unbanked centers has witnessed a consistent increase in recent years driven by aggressive rural expansion by private sector banks.

Source: *RBI*

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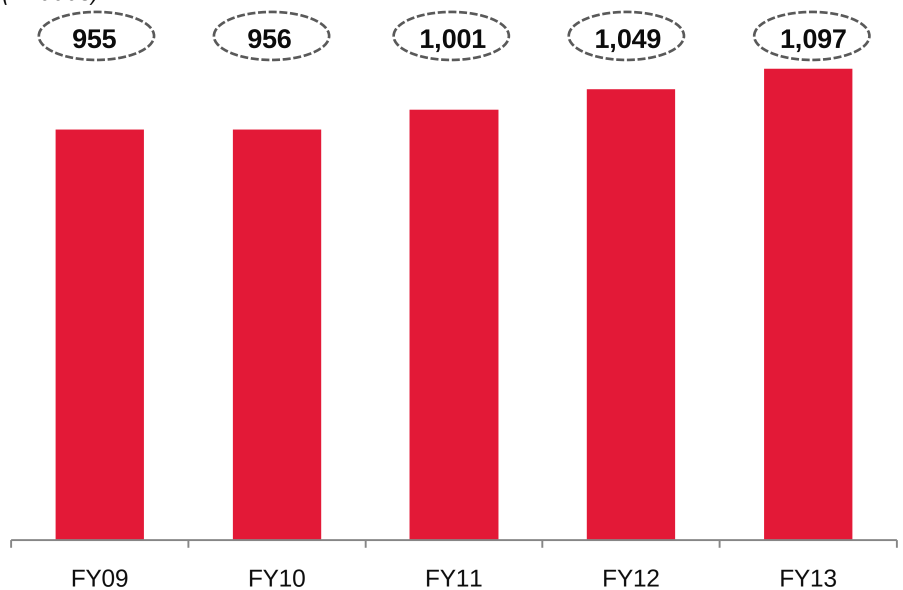
Private sector banks continue to contribute to employment growth amid rapid expansion

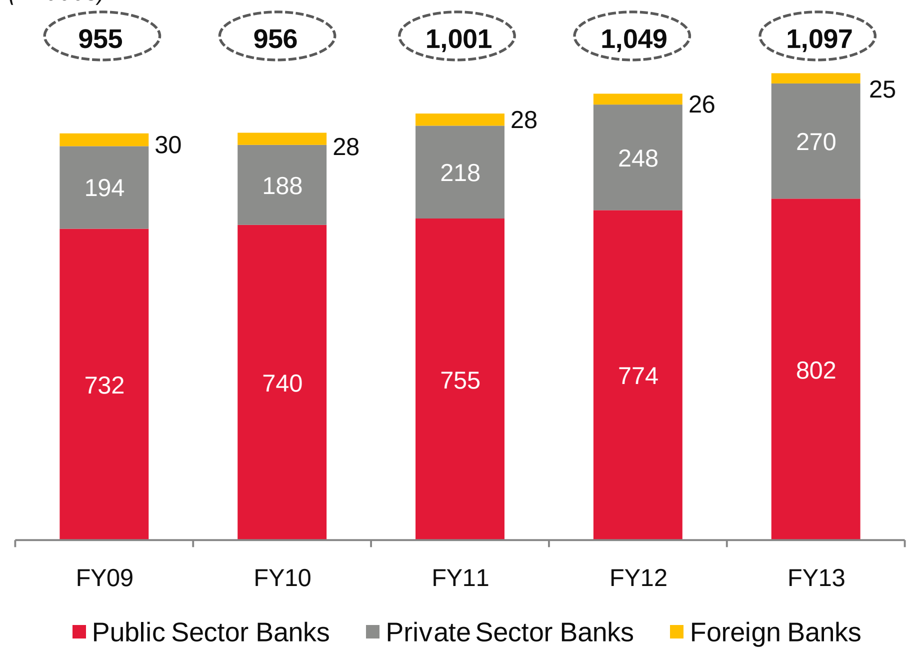
TOTAL NUMBER OF SCB EMPLOYEES

(in '000s)



NUMBER OF BANK EMPLOYEES – BY BANK GROUP

(in '000s)



- Overall employment levels in the Indian banking system increased at a CAGR of 3.5% during the FY09-FY13 period. The main drivers of these employment trends have been the private sector banks which witnessed a growth of 8.7% CAGR in their number of employees during the same period.
- On the other hand, public sector banks (PSBs) grew at a CAGR of 2.3% while the foreign banks saw a decline of -3.8% in the employment levels.

Source: *RBI*

Banks offer a wide range of products across retail, wholesale and treasury segments

SEGMENTATION & OFFERINGS

RETAIL BANKING

LOAN PRODUCTS

- Auto & personal loans
- CV & construction equipment finance
- Credit/debit cards
- Loans against gold
- Agri & tractor and education loans

DEPOSIT PRODUCTS

- Savings accounts
- Current accounts
- Fixed / recurring deposits
- Corporate salary accounts

OTHER OFFERINGS

- Depository accounts
- Mutual fund, insurance and gold sales
- Private banking
- NRI, bill payment & foreign exchange (forex) services
- POS terminals

WHOLESALE BANKING

COMMERCIAL BANKING

- Working capital & term loans
- Bill collection
- Wholesale deposits
- Forex & derivatives
- Letters of Credit & Guarantees

TRANSACTIONAL BANKING

- Cash management
- Custodial and clearing bank services
- Correspondent banking
- Tax collections
- IPO underwriting

INVESTMENT BANKING

- Debt capital markets
- Equity capital markets
- Project finance
- M&A and advisory

TREASURY OPERATIONS

TREASURY PRODUCTS

- Forex
- Debt securities
- Derivatives
- Equities

OTHER FUNCTIONS (INTERNAL)

- Asset liability management
- Statutory reserve management

OTHER BANKING ACTIVITIES

OFFERINGS

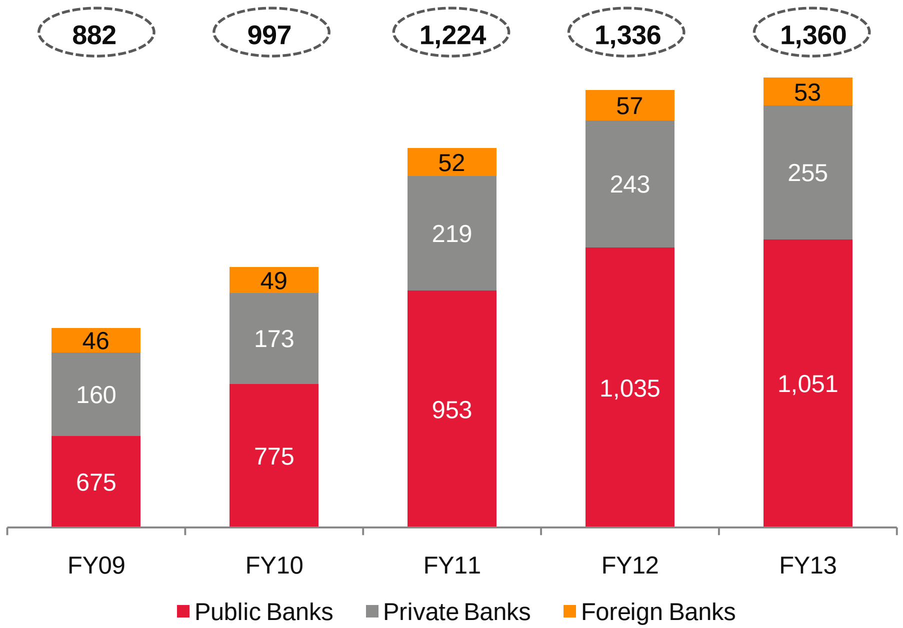
- Leasing operations
- Dealership business
- Third-party product distribution

Source: *Dun & Bradstreet, Bank websites*

Deposit growth has been primarily driven by current & savings accounts, while assets have grown at a modest pace

BANK DEPOSITS

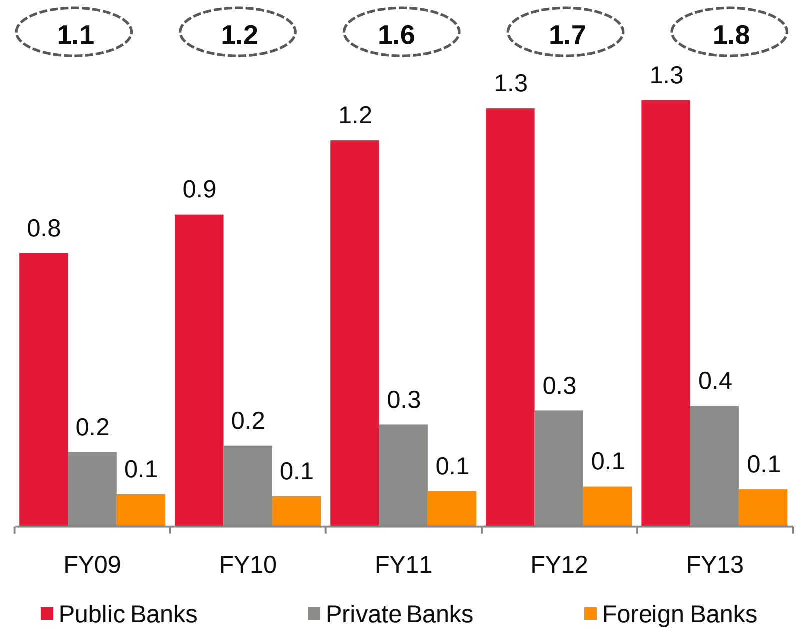
(USD billion)



- Deposits increased at a CAGR of 11.4% during FY09–FY13 to reach USD1,360 billion in FY13.
- Growth in deposits was primarily due to strong growth in current account savings account (CASA) (33% growth in FY13). CASA growth was strong for new private sector banks, due to their higher savings deposit rates.

TOTAL ASSETS

(USD trillion)



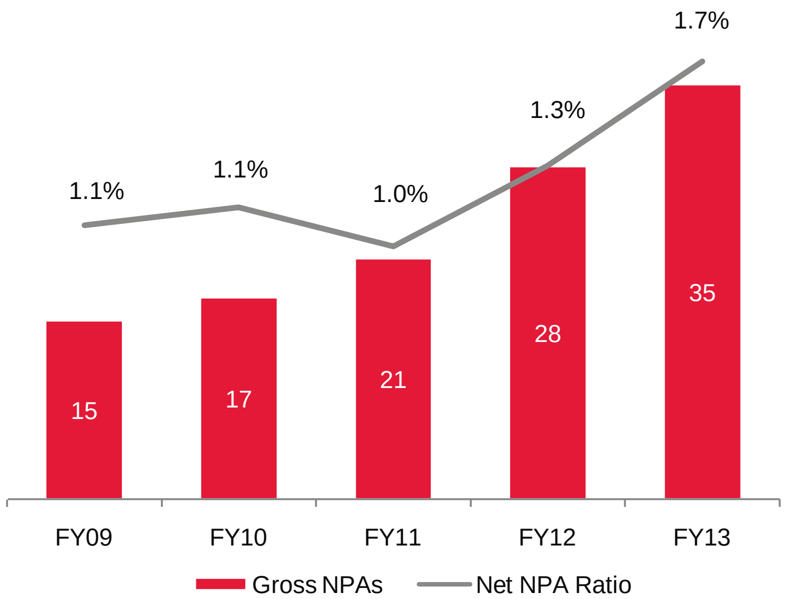
- Total banking sector assets increased at a CAGR of 11.3% to USD1.8 trillion in FY13.
- Public sector banks accounted for majority (73%) of the total assets in FY13.

Source: *RBI report on trend and progress of banking in India 2012-13*

However, asset quality and profitability has been declining for the past two years due to effects of economic slowdown

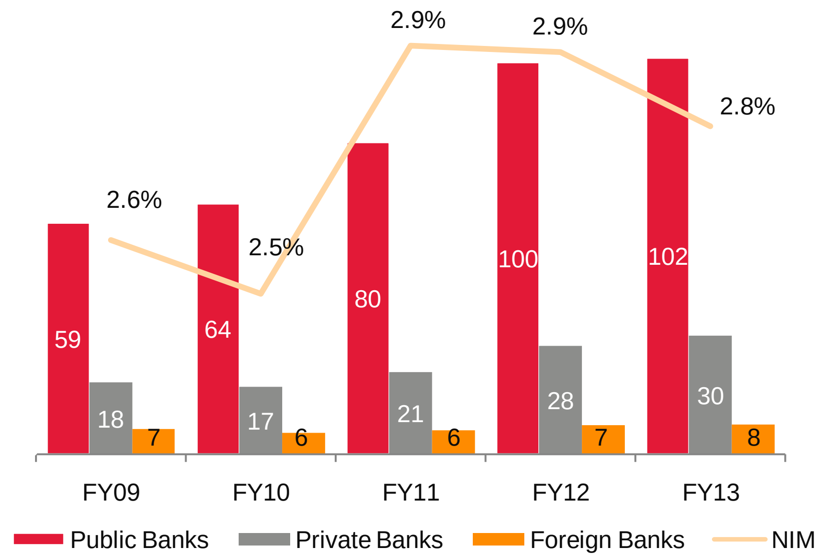
NON-PERFORMING ASSETS

(USD billion, %)



INTEREST INCOME & NET INTEREST MARGIN

(USD billion, %)



- Asset quality continued to worsen due to decreasing GDP growth, policy hurdles, aggressive expansion by corporates during the boom phase with resultant excess capacities and deficiencies in credit appraisal.
- Within non-performing assets (NPAs), the proportion of doubtful loan assets has increased, especially among PSBs.

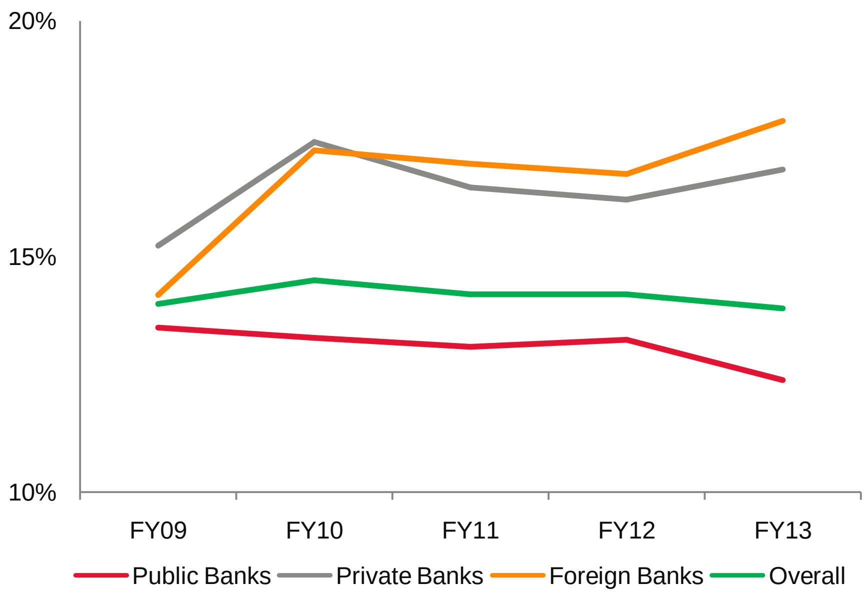
- Net interest margins (NIM) declined marginally in FY13, due to subdued credit demand, fall in yield on funds, less than proportionate fall in cost of funds and sharp rise in non-performing assets.
- Margins pressures were higher in case of PSBs compared to private sector and foreign banks on rising cost of funds

Source: *RBI report on trend and progress of banking in India 2012-13*

Capital strength of banks continues to be robust while return on assets has been almost stagnant over the last five years

CAPITAL ADEQUACY RATIO

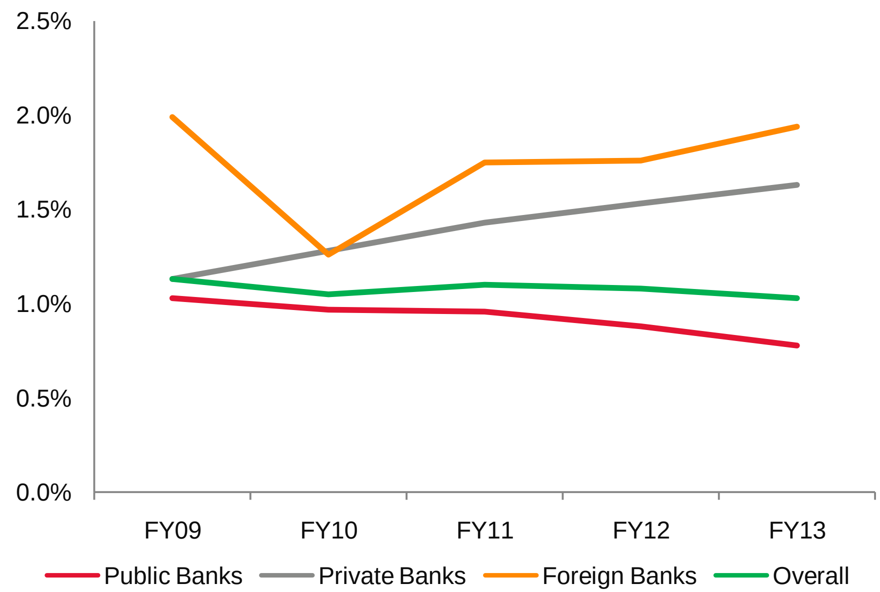
(%)



- Continuing with the past trend, the capital adequacy ratio (CAR) remained above the stipulated 9% norm both at the aggregate and bank group levels in FY13; however, it saw a marginal decline in FY13.
- The decline in capital level at the aggregate level was due to deterioration in the capital positions of PSBs.

RETURN ON ASSETS

(%)

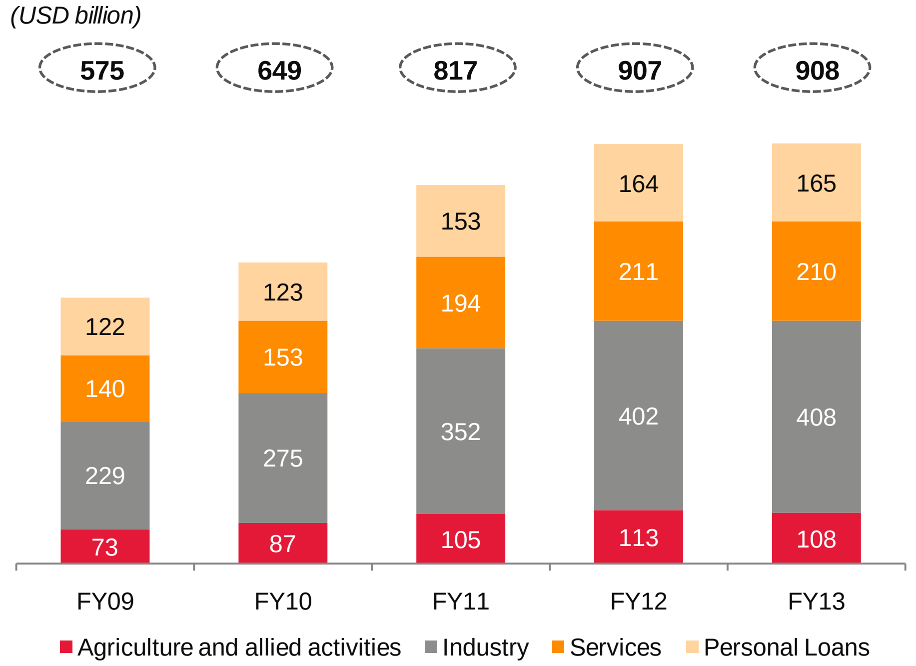


- The return on assets (ROA) for the banking sector reduced further by about 5 basis points in FY13.
- This reduction was discernible in the case of PSBs in general, and nationalized banks in particular. New private sector banks and foreign banks managed to improve their returns on assets by reducing operational costs.

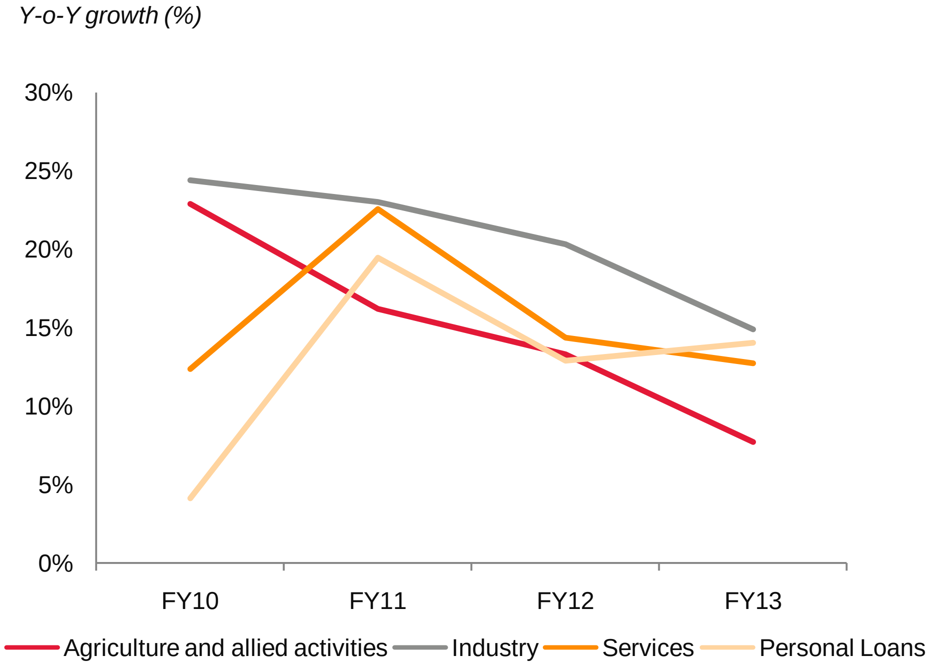
Source: *RBI report on trend and progress of banking in India 2012-13*

Credit off-take across most major sectors has remained weak amid growth in retail loans

SECTORAL DEPLOYMENT OF BANK CREDIT



GROWTH IN CREDIT TO MAJOR SECTORS



- FY13 witnessed a slowdown in the growth of credit in major sectors, including the industry sector as well as agriculture and allied activities. Slowdown in the industry sector was primarily due to a sluggish infrastructure sector impacted by regulatory delays, power supply issues, and delays in land acquisition.
- Growth of services sector credit declined due to slowdown in credit to non-banking financial companies (NBFCs), which accounts for about one-fifth of the total credit to the services sector.
- Retail loans segment however grew in FY13, as banks increased their focus on this segment to offset sluggish growth in other segments.

Source: *RBI sectoral and industrial deployment of bank credit return (monthly), RBI report on trend and progress of banking in India 2012-13*

Mobile banking, focus on fee-based segments and high-growth markets, and increased investments in technology are the key trends

RISING FOCUS ON MOBILE BANKING

- Banks are increasingly adopting mobile-based channels as delivery channels to expand reach and lower costs since opening bank branches comes with its associated regulatory and financial restrictions.
- In recent years, the mobile banking has been reflecting a growing trend with the volume and value increasing by 108.5% (53.30 million in FY13 vis-à-vis 25.56 million in FY12) and 228.9% (USD1.1 billion in FY13 vis-à-vis USD0.2 billion in FY12), respectively.

SHIFT TO FEE-BASED BUSINESS MODEL

- Banks are looking to increase fee-based income by shifting focus to selling life and general insurance policies through bancassurance tie-ups or as insurance brokers.
  - *Recent bancassurance tie-ups include Indian bank with United Indian Insurance, PNB with Metlife, and Axis Bank with Max Life insurance.*
- Retail fee income (insurance and mutual funds sales commissions, transaction fees on savings & current accounts, consumer loans & credit cards' processing fees, and fees from forex transactions & remittances) has been another focus area.

ADOPTION OF DIGITAL TECHNOLOGIES

- Owing to the increased number of scandals in the industry and stricter policies from the Reserve Bank of India (RBI), Indian banks are looking to upgrade their technology systems to analyze real-time data to predict fraud or illegal activities.
- RBI has decided to implement a national General Interbank Recurring Order (GIRO)-based Indian Bill Payment System to enable households to use their bank accounts for paying school fees, utilities, and medical bills as well as making online remittances.

FOCUS ON EMERGING SECTORS & RURAL MARKETS

- The tough macroeconomic situation in India is driving private-sector banks to sharpen their focus on emerging sectors and rural markets to boost growth.
  - *YES BANK, for example, has defined a growth strategy focused on emerging sectors such as life sciences, IT, education, and healthcare.*
- Some private banks are also setting out branches to strengthen their rural presence. Examples include ICICI, HDFC, Axis Bank, etc.

Source: *KPMG, Confederation of Indian Industry (CII), RBI, Accenture*

Favorable economic/demographics, infrastructure investments are likely to drive growth; however, rising NPAs and capital requirements remain key challenges

KEY GROWTH ENGINES

- **Economics & Demographics:** According to the World Bank projections, India's economy is projected to grow at over 6% in FY14–FY15 and 7.1% by FY16–FY17 owing to global demand recovery and increase in domestic investment. This is likely to drive growth in the banking system. Furthermore, India has over 1.2 billion people under the age of 25. This represent a large potential bankable population and present a unique opportunity for the banking system to expand its customer base.
- **Financial Inclusion:** Approximately 41% of the adult population currently does not hold bank accounts in India, reflecting a large untapped market. With the Government of India (GoI) and the RBI prioritizing financial inclusion and issuing new banking licenses, banks have been encouraged to expand their network through setting up of new rural branches.
- **Infrastructure Development:** India needs significant investment in infrastructure to sustain long-term growth momentum. Investment requirement in infrastructure is expected to increase at a CAGR of 14.6% from FY08 until FY17. Bank finance would be of critical importance to the sector.
- **MSME Sector:** The Micro, Small and Medium Enterprises (MSME) segment accounts for 45% of the India's industrial output and contributes about 11.5% of GDP. However, the segment faces a chronic shortage of bank financing for growth. This unmet demand presents a significant opportunity for the flow of banking credit.

KEY GROWTH INHIBITORS

- **Low Banking Penetration:** The current all-India CRISIL Inclusix score of 42.8 (on a scale of 100) reflects under-penetration of formal banking facilities in India. Only one in two Indians has a savings account and one in seven has access to bank credit.
- **Increasing NPAs and Restructured Assets:** Slowdown in economic activity and aggressive lending by banks have rendered many loans non-performing, impacting the banks' profitability. Going forward, the key challenge for banks is to increase loans and effectively manage NPAs while maintaining profitability.
- **Implementation of Basel III:** Basel III norms on capital requirements may not affect Indian banks as most of them are operating at 6–8% of common equity. However, going further, if loan growth outpaces internal capital generation, banks may face challenges in terms of adequate capital for growth. Public sector banks would have to rely on a combination of government capital infusion and equity markets to support their capitalization.
- **Leadership Vacuum in PSBs:** Over 0.2 million personnel from the baby boomer generation, who are currently in senior and middle management roles in PSBs, are due to retire in the coming 5–10 years. Many PSBs may not have a strong talent pipeline to replace these retiring personnel.

Source: *KPMG, Planning Commission's XIth and XIIth five-year plan*

Outlook for the Indian banking sector is positive led by robust growth in deposits and a potential recovery in credit off-take amid pressures from declining asset quality

OUTLOOK FOR THE INDIAN BANKING SECTOR

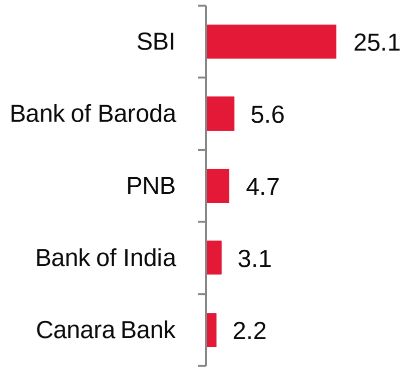
		RATIONALE
Deposits	⬆	The RBI's estimate of the banking system's deposits' growth for FY14 is 14%. Deposits are expected to grow due to rise in interest rate on savings bank deposits which in turn would encourage household savings, RBI's efforts to attract NRI deposits among others.
Credit off-take	⬆	As per the RBI's estimates, bank credit is estimated to grow 15% in FY14. The increase in credit could be attributed to demand for short-term loans, working capital, and retail segments.
NPAs	⬇	NPAs to total loan ratio in India rose from 2.3% to 3.6% between 2009 and 2012 and is projected to reach 5% by the end of 2014. Some of the factors leading to rise in NPAs include investment-related policy hurdles in a low-growth, high-inflation (stagflation) environment and poor lending practices of several banks.
New branches	⬆	Banks will continue to focus on expanding their network. According to Gartner research, about 2,000 new branches would be added in India by the end of 2014. This would result in increased employment in the sector.

Source: *RBI, The Times of India, The Hindu BusinessLine*

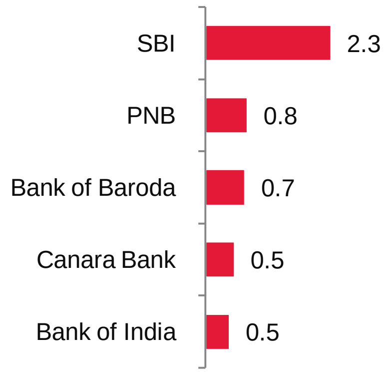
SBI is the biggest public sector bank while HDFC Bank and ICICI Bank lead the private banks

TOP FIVE PUBLIC SECTOR BANKS

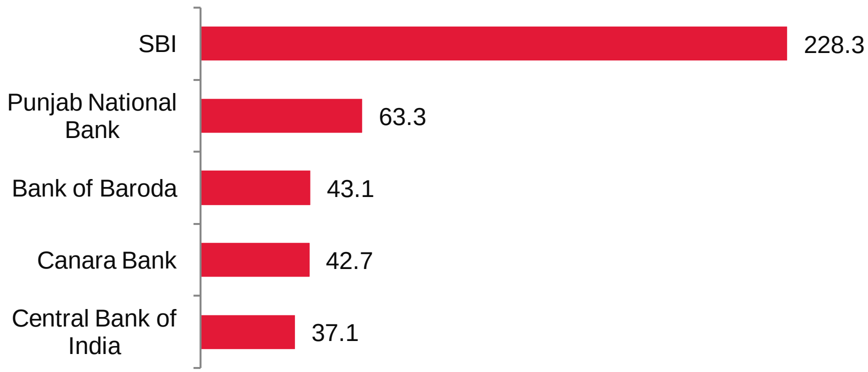
By Market Cap (USD billion)



By Net Profit (USD billion)

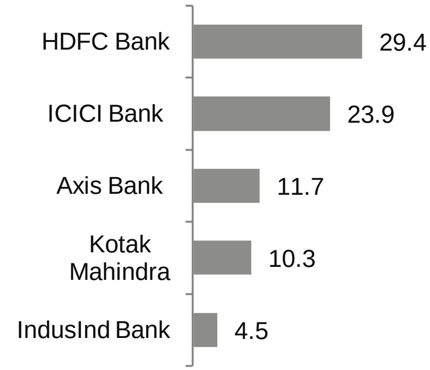


By Employment (in '000s)

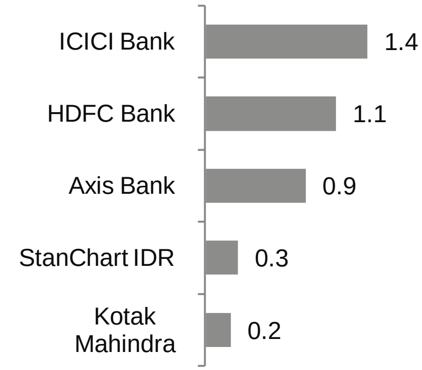


TOP FIVE PRIVATE SECTOR BANKS

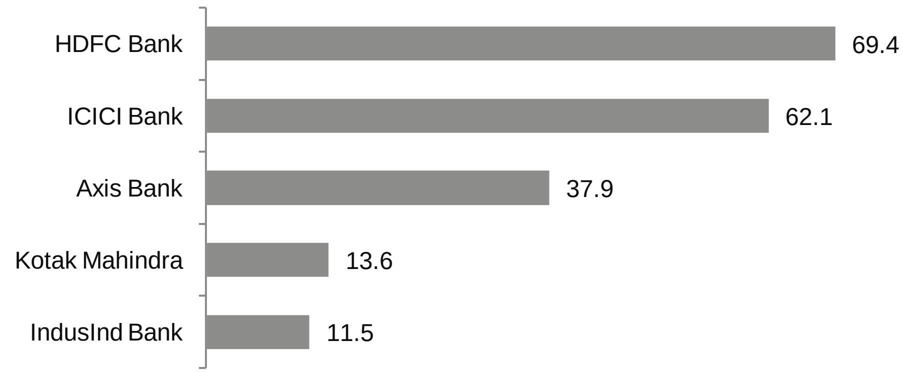
By Market Cap (USD billion)



By Net Profit (USD billion)



By Employment (in '000s)



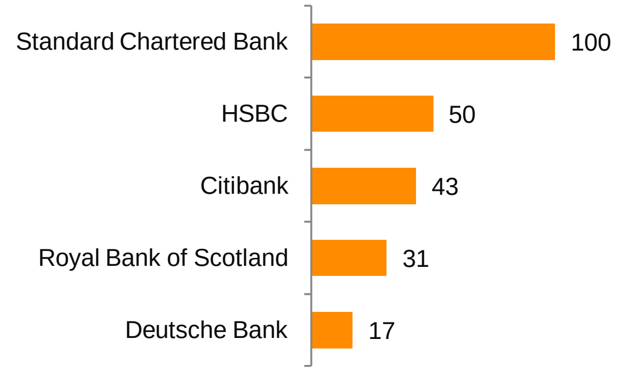
Source: *MoneyControl.com, RBI*

Note: *1) Data as on 31st March, 2013 except for Market cap which is as on 10th April, 2014 2) Branches include administrative offices 3) 1 INR = 0.0166 USD*

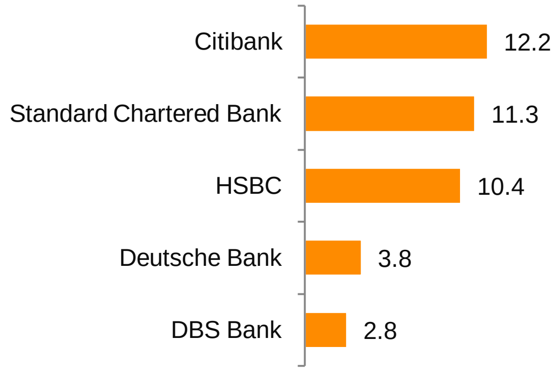
Among foreign banks, Standard Chartered and Citibank are the largest banks

TOP FIVE FOREIGN BANKS

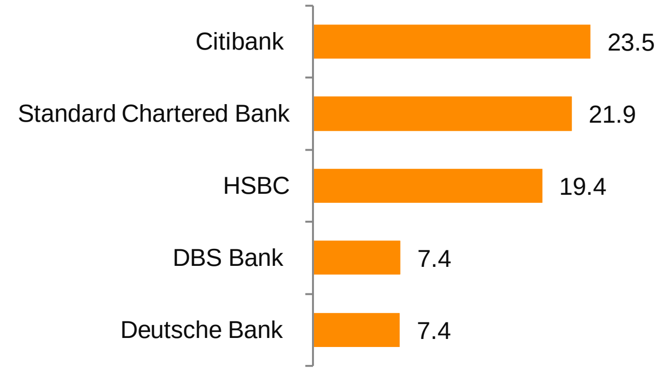
By No. of branches



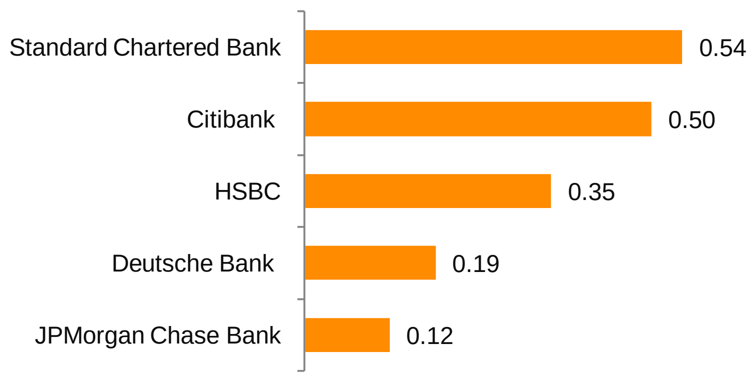
By Deposits (USD billion)



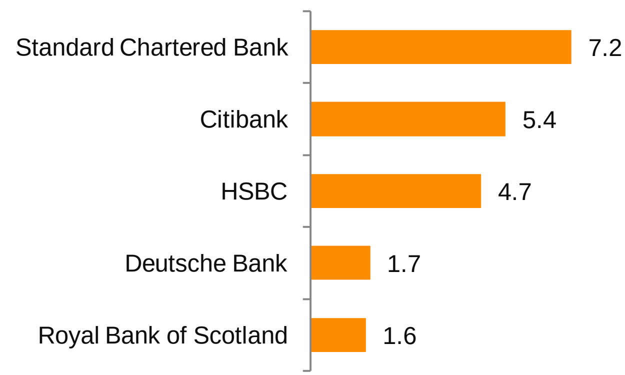
By Total Assets (USD billion)



By Net Profit (USD billion)



By Employment (in '000s)



Source: *RBI*

Note: *1) Data as on 31st March, 2013 2) Branches include administrative offices 3) 1 INR = 0.0183 USD*

New banking licenses, relaxation in foreign ownership stakes are the key regulations…

Particulars	Description	Implications
Issuance of New Banking Licenses	▪ The entity must have a public shareholding of at least 51%. Additionally, it should possess sound credentials, i.e. Rs 5 BN capital and a minimum track record of 10 years to be allowed to enter the banking business. ▪ In 2013, the RBI guidelines also specified a new holding structure for the new banks, which stipulate that at least 25% of their branches have to be in rural areas.	▪ Increasing the number of banks would promote financial inclusion, foster competition, and thereby reduce costs and improve the quality of banking services.
WOS by Foreign Banks	▪ The new guidelines enable foreign banks to open branches anywhere in the country as well as acquire domestic private sector banks, and permits stake dilution up to 74% or less. ▪ WOS by foreign banks should have an initial minimum paid-up voting equity capital of Rs.5 BN (for new entrants), should meet the Basel III norms, and maintain a minimum CRAR.	▪ The framework provides foreign banks with an opportunity to refine their India market plans in terms of capital and management commitments to size the growth opportunities in form of both organic as well as inorganic options.
Priority Sector Lending*	▪ Domestic banks are required to tender 40% of their advances towards priority sector, while the limit for foreign banks is at 32% of their total advances.	▪ Provision of easy, adequate and timely credit to priority sectors that otherwise would not receive easy finance.

Source: *RBI, Deloitte, Livemint, Business Today*

Note: ** Priority sectors include Agriculture, Micro & Small enterprises, Education, Housing, Export Credit, etc.*

…in addition to foreign investment caps in PSBs and higher capital requirements

Particulars	Description	Implications
FDI Limit in Banks	▪ The aggregate foreign investment (FDI, FII and NRI) cannot exceed 74% in private sector banks while the ceiling is at 20% for nationalized banks, SBI, and its associate banks.	▪ The FDI inflows would help banks to meet their capital requirement, and ensure better and improved risk management, thereby making the Indian banking sector more competitive.
Basel III Norms	▪ Under Basel III norms, being implemented in phases, the banks need to have a core capital ratio of 8% and a total CRAR of 11.5% against 9% now.	▪ These would help to strengthen the regulation, supervision, and risk management of the Indian banking sector thereby reducing the risk of spillover from financial sector to real economy.

Source: *RBI, Deloitte, Livemint, Business Today*

Deals & moves in the sector

2010

Merger with

The integration of BoR helped ICICI Bank to increase its branch network by 25% to about 2,500 across India. It also gave greater visibility to the bank in the western and northern parts of the country.

USD667 million

2010

Merger with

The merger helped both the banks by eliminating competition between the two and providing better access to funds at economical rates.

NA

2008

Merger with

The merger helped HDFC Bank to penetrate in the rural areas.

USD2.5 billion

Source: *Economic Times, ICICI Bank, HDFC Bank*

Going forward, wholesale banking, MSME and rural segments are likely to be the most attractive segments

INDIAN BANKING VS. PEER COUNTRIES (2013)

Countries	Regulatory CRAR	Bank Capital to Assets	Bank NPL to Total Loans	ROA	ROE
Australia	11.6	5.6	1.4	1.2	20.2
France	15.2	5.4	4.3	0.5	9.4
Italy	13.8	5.5	15.1	0.0	0.7
Singapore	16.4	8.2	0.9	1.2	15.3
UK*	16.4	5.0	3.7	0.3	5.8
US	14.4	11.8	2.6	1.6	11.6
Russia	13.5	11.5	6.0	1.9	14.0
China	12.2	6.7	1.0	1.3	19.2
India	12.6	6.9	3.8	0.8	11.1
Malaysia	14.7	9.3	2.0	1.5	15.6
Brazil	16.1	9.3	2.9	1.4	14.0

- India ranks low with respect to non-performing loans and ROA while performing moderately in other parameters (ROE, CRAR, Capital/Assets)

ATTRACTIVE PRODUCT/MARKET SEGMENTS

- **Wholesale Banking**: As per McKinsey's estimates, revenues from the wholesale banking segment, which account for nearly 30% of total banking revenues, are expected to more than double, from USD16 billion in FY10 to USD35–40 billion by 2015.
  - Within the wholesale segment, project finance and investment banking are expected to see the fastest growth in terms of revenues.
- **MSME Segment:** Decline in borrowing by large corporates and emerging credit quality stress in retail segments such as commercial vehicle and commercial equipment finance have led to growing focus by private sector banks on the small and medium enterprises (SME) segment to drive growth. MSME (micro, small and medium enterprises) or business banking is expected to spur growth for private banks as public sector banks are challenged by capital constraints. Focus on MSME segment will also help banks to improve their margins.
- **Rural Banking**: As banks seek to increase their customer base, the relatively untapped rural population in India is likely to offer attractive opportunities. Private banks will continue to lead the rural expansion with opening of new branches and launch of simpler products to cater to the rising demand from customers.

Source: *Financial Soundness Indicators (FSI): IMF, McKinsey & Company*

***Note**: 1) CRAR: Capital to risk-weighted assets 2) NPL: Non-performing loans 3)* Represent 2012 figures*

KEY COMPANY FACTS

Incorporation date	1994
Bank Type	New Private Sector Bank
Headquarters	Mumbai, India
No. of Branches	3,753
No. of ATMs	11,292
Presence	Worldwide (19 countries)
Website	www.icicibank.com

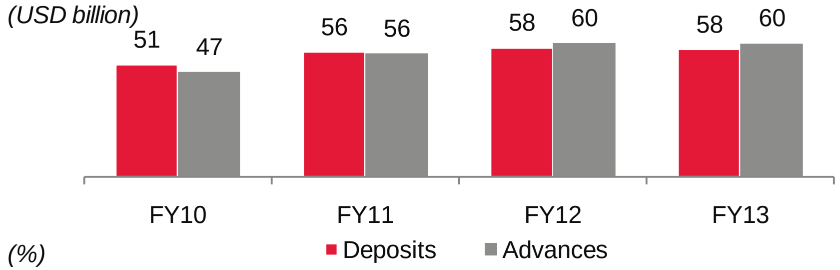
BUSINESS DESCRIPTION

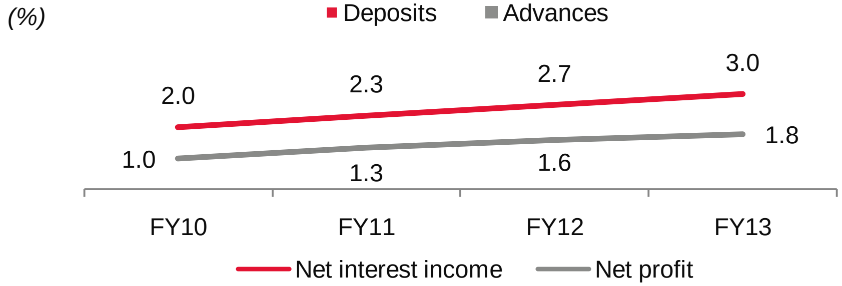
- ICICI Bank is an Indian multinational banking and financial services company.
- It is India's largest private sector bank and the second largest bank by assets and market cap as of 2014.

BUSINESS SEGMENTS

- Retail Banking
- Wholesale Banking
- Treasury
- Other Banking Businesses

FINANCIAL PERFORMANCE





KEY DIFFERENTIATING STRATEGIES

- **Rural & inclusive banking**: Over the last 18 months, ICICI has set up 60% of its branches in rural areas, of which over 400 have been set up in unbanked villages. ICICI Bank currently provides banking services to nearly 15,000 villages, an increase of over 20 times in last 3 years.
- **Use of innovative technologies**: ICICI Bank is one of the pioneers in using innovative channels of branch, mobile, and internet banking, ATMs, and social media to offer customized services.

Source: *ICICI Bank website*

KEY COMPANY FACTS

Incorporation date	1994
Bank Type	New Private Sector Bank
Headquarters	Mumbai, India
No. of Branches	3,336
No. of ATMs	11,473
Presence	Worldwide
Website	www.hdfcbank.com

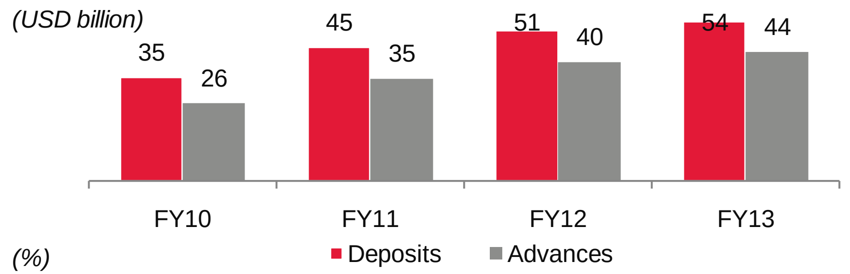
BUSINESS DESCRIPTION

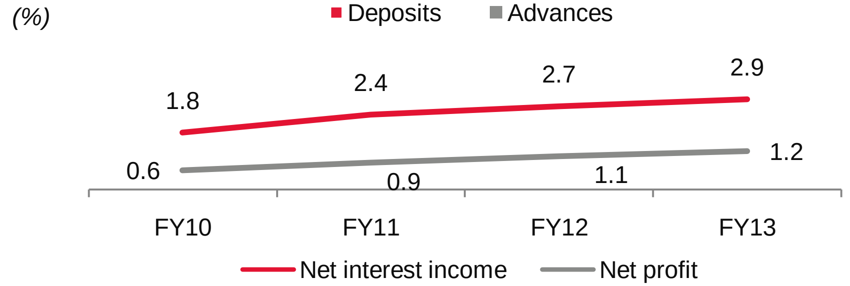
- HDFC Bank Limited is an Indian financial services company.
- HDFC was amongst the first to receive an 'in principle' approval from the RBI to set up a bank in the private sector, as part of RBI's liberalization of the Indian banking industry in 1994.

BUSINESS SEGMENTS

- Treasury
- Wholesale Banking
- Retail Banking
- Other Banking Businesses

FINANCIAL PERFORMANCE





KEY DIFFERENTIATING STRATEGIES

- **Extensive ATM network**: Leading private sector bank with a large network of over 11,000 ATMs. The bank has an ATM/Branch ratio of 3.4 compared to 3.0 for ICICI Bank. In 2013, HDFC Bank also launched a pilot program for solar-powered ATMs.
- **Focus on semi-urban & under-banked markets**: Added 518 branches including 193 micro branches (2–3 member branches) in FY13 to strengthen their rural presence. Over 88% of the bank’s new branches were set up in in semi-urban and rural areas during the same period.

Source: *HDFC Bank website, RBI*

IMPORTANT NOTES

- Old Private Sector Banks are the banks which were not nationalized at the time of bank nationalization, which occurred during 1969 and 1980.
- New Private Sector Banks are banks that came into operation post1991, with the introduction of economic reforms and financial sector reforms.
- Urban Co-operative Banks include Multi-State Urban Co-operative Banks and Single State Urban Co-operative Banks
- Rural Cooperatives include Short-Term, State Co-operative Banks, District Central Co-operative Banks, Primary Agricultural Co-operative Societies, Long-Term, State Co-operative Agriculture and Rural Development Banks, and Primary Co-operative Agriculture, and Rural Development Banks
- Figures may not sum up to the total in view of rounding-off to the nearest whole number.
- FY refers to Indian financial year from April to March.
- CAGR stands for compounded annual growth rate.
- GDP refers to gross domestic product.
- Numbers for Scheduled Commercial Banks include numbers for public sector banks, private sector banks and foreign banks only as these three bank groups account for over 90% of the total banking sector assets.

EXCHANGE RATES

Fiscal Year	INR equivalent of one USD
2008–09	46.08
2009–10	47.62
2010–11	45.87
2011–12	48.31
2012–13	54.64

Source: *OANDA*