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Italian and Indian Banks:
Recent Trends & Growth Opportunities

By

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Strengths of Indian Banking Sector

- Banks in India– a dominant financial intermediary characterised by relatively low credit penetration (% of bank loans to GDP at 50.0% in FY07)
- Size of the banking sector (deposits + credit) has gone up more than seven times from Rs 5,984 billion in FY95 to Rs 45,372 billion in FY07
- Fifteen years of financial sector reforms have strengthened the banks' balance sheets considerably
  - Gross NPLs (%) declined from 15.7% in FY97 to 2 .7% in FY07
  - Strong Capital Adequacy Ratio at 12 .3% in FY07
- Sector is tightly regulated & monitored by the RBI
  - Exposure to overseas markets has been limited and close supervision of RBI has helped avoid any crisis.
- Vulnerable asset categories like unsecured consumer loans, capital market exposures & real estate lending comprise less than 10% of total loans.

Strengths of Indian Banking Sector

- Creditors' rights have consistently improved & banks are increasingly recovering from delinquent accounts through negotiated settlements.

- New innovative instruments are being introduced for "capital raising" and all large banks are well prepared to migrate to Basel II by end-FY08.

- All banks including the PSBs have aggressively implemented the Core Banking Solutions and moved away from Vanilla Banking to Multi-Specialist Banking.

- Domestic lending is highly diversified across sectors & classes of borrowers. This along with a cautious regulatory environment, helps to contain banking sector risks.

- Indian banks do not have exposure to the US subprime market and limited investment in CDOs (mainly of Indian entities) has manageable mark-to-market losses.

Assessment of Indian Banks by Ratings' & Other Agencies

- **Moody's (12 July 2007): Stable Outlook**. It states that "the rating is driven by relatively solid financial metrics amid a benign operating environment conducive to credit growth".

- **Fitch (20 Aug 2007): Stable Outlook**. It says, "The strong domestic franchise and reach of the larger Indian banks have helped them exploit the growth opportunities in a rapidly expanding Indian economy".

- **Standard & Poor's (11 Sept 2007):** It says that "Indian banks are reasonably well placed compared with their Asian peers". It places India's banking sector in Group 6 of its banking industry risk assessment parameter, on par with China and Thailand, but lower than Malaysia (Group 4) and Singapore and Hong Kong (Group 2).

- **EIU (Economist, 2 Oct 2007): Stable Outlook**. It says that, "India's banking sector is generally cautious and conservatively regulated. Indian banks are not directly exposed to the turmoil in global financial markets that was triggered in August 2007 by the unravelling of subprime mortgage lending in the US".

International Competitiveness of Indian Banks

According to Moody's Investor Services' Study (July 2007) based on the last three years' average performance,

- Indian lenders have the highest ROE (Return on Equity) in Asia (20.38%), followed by Indonesia (20.19%), New Zealand (18.83%), and Japan (-6.42%)
- Indian Lenders have the lowest "average gross bad loans" as % total loans (last 3 years): India (8.18%), Phillipines (15.05%), Thailand (13.08%), China(11.80%) and Malaysia (9.73%).
- Cost to Income ratio in India too is relatively low at 44.56% with banks of only three countries with better ratio: Singapore(44.15%), Taiwan (42.61%) and Hong Kong (40.05%).

• In short, India fares better than its Asian Peers in terms of key performance indicators for last three years.

Why Global Banks are Banking on India?

- India is viewed as one of the biggest growth stories among emerging markets
    - Real GDP growth for last four years (FY04 to FY07) averaged 8.6% and growth rates during the last two years above 9.0%
    - Acceleration in Gross Domestic Investment rate from 24.3% in FY01 to 33.8% in FY06
    - Average non-food credit growth of the banking sector for last three years (FY05 to FY07) was robust at 29.3% and is expected to be around 25% in FY08
    - Infrastructure, SMEs, farm credit and retail sectors have primarily been powering the growth of bank credit in India.
- Estimated demand for funds from the infrastructure sector is quite huge.
    - Gross Capital Formation in infrastructure sector for 11th Plan period (FY07 to FY12) is estimated at $569 billion.

Why Global Banks are Banking on India?

- Credit flows of banks to infrastructure sector are expected to grow at the CAGR of 25% till FY12 (Source: IDFC)

- Retail credit too has been growing in robust fashion at about 22% and bankers expect similar growth rates to sustain over next 5 to 10 yrs.

- Buoyant economic growth & "wealth effect" of surging capital markets are the major triggers for growth in consumer loans

- The number of millionaires in India has crossed the 1,00,000- mark and salaries in India have witnessed 13% to 14% growth – higher than that seen in China & SE Asian countries.

- Cars, white goods, computers & entertainment electronics have become much more affordable with the Government steadily lowering tariff level on both the domestic/imported goods.

- Ever increasing demand, rising income levels, fiscal concessions, probability of low default due to social importance of a house & comfortable liquidity in the banking system have created huge potential for housing finance business.

Why Global Banks are Banking on India?

- Expanding market for SME finance (expected CAGR for next 4-5 years at 30.0%).
  - Growth of the SME sector in last eight years (average of 8.0%) has been more than that of the industrial sector (average of 5.0%).
  - India has approximately 400 modern small scale and 2,000 rural & artisan based clusters, which contribute around 60% of India's manufactured exports.
  - SMEs are enjoying increasing support from government in terms of credit & finance, technology, business development, infrastructure & other areas.
  - Many of today's corporates had their origins in smaller enterprises, which were able to expand in line with emerging opportunities.
  - There are no policy restrictions on FDI in small units, except if they are in the reserved category.

Why Global Banks are Banking on India?

- Enormous opportunities for lending to rural economy,
  - Especially to "new agriculture" of high-value products such as fruits, vegetables, dairy and meat products, for which both domestic and export demand are very high.
  - Rural markets are expanding at a faster pace. A recent Survey shows that 53% of FMCG sales and 59% of Consumer Durables sales take place in rural areas.
  - Of the 2 million mobile connections, 50% went to small towns & villages.
- Newer areas like insurance, mutual fund distribution, credit cards, leasing, asset management, advisory services, wealth management, etc. have created opportunities to diversify the revenue streams and enhance non-fund based income.

Why Global Banks are Banking on India?

- Foreign banks operating in India are increasingly financing global aspirations of Indian corporates & help them raise funds (debt or equity) or finance their acquisition plans.
  - For instance, Citibank has reportedly helped in financing up to $15 billion of acquisitions by Indian corporates overseas.
- Banks are also seeing increased action in transaction based businesses such as bill discounting in India
- Bankable household in India is anticipated to grow at CAGR of 28.1% during 2007-2011.
- Size or lack of it remains the "key" to banks' growth aspirations in India.
  - The "announcement" of a roadmap of banking reforms spurred a series of investments by foreign banks into India.

Why India Needs Global Banks?

- Shareholder value creation is at the core of foreign banks' strategy
- Their presence helps in global integration and outsourcing
- Entry of foreign banks has generally been associated with improvements in the quality of regulation (international standards of accounting and audit) and transparency
- Help create a competitive banking sector
- Bring in product innovations and global offerings (multi currency dealings)
- Transfer latest technology
- Known for value creation across customer segments
- Sophisticated risk (credit scoring), pricing and CRM systems
- Most importantly, foreign banks' entry reduces financial constraints in the economy.

Risks Associated with Foreign Banks

- Too much concentration on the top end of the market
- Risk of hostile takeovers
- Can act as a source of contagion from events taking place in the external world
- Generally bring with them complex derivative products, which may destabilise the markets.
- But this is more of a problem for the "regulators" and Indian Financial Regulation is known for its stricter vigilance to tackle these complexities.
- Current PSB corporate governance structure needs to be evolved into one in which there is high level of managerial professionalism and diverse ownership structure.

Prsent Indian Concerns

- India’s current pace of expansion (at 9.0% plus) may get constrained by the weaknesses in national infrastructure, notably power, roads, ports and airports.
- Expanding scale of demand for capital and credit require –
    - Strong Credit Market
    - Strong Corporate Bond Market
    - Strong FDI Inflows
- Indian Government is already heavily indebted and has its own targets for deficit reduction and hence, will not be able to directly fund the enormous requirements for credit.
- Indian Corporate Bond Market is underdeveloped and illiquid.
- India attracts relatively lesser proportion of FDI inflows.

Present Indian Concerns

- According to the RBI estimate, in order to maintain an average CRAR of 12.0% by March 2010, the PSBs would require an additional capital of Rs 2,980 billion.
  - This is arrived at after considering the requirement of capital to fund growth, expected NPL writeoffs, investments in IT and other infrastructure.
- Entry of foreign banks to a large extent would help enhance the availability of loanable funds in the banking system
- But other measures such as development of corporate bond market, allowing banks to raise capital through innovative, hybrid instruments, fiscal consolidation, relaxation of investment restrictions on pension funds & insurance companies should be pursued with a firm roadmap.

Present Indian Concerns

- In order to ensure pure competition between domestic and foreign players, the Regulators should pay serious attention to level playing field and reciprocity issues.
- The RBI's roadmap may be viewed as fulfilling the key objectives of competition, consolidation and convergence in the sector.
- Opening up the sector for foreign banks or "infusion of foreign capital" may help resurrect weak banks in the private sector.
- "M & As" which are stuck in the banking sector due to political reasons may become more common after FDI in banking is allowed more easily.
- Consolidation and Convergence of banks within India has not kept pace with global phenomena
    - The entry of foreign banks would greatly facilitate this process.

Conclusion of PWC Report

- The banking world in 2050 will be radically different from the one we see today with E7 economies (India, Brazil, Russia, China, Indonesia, Mexico & Turkey) becoming at least as important as G7 (US, Japan, Germany, UK, France, Italy and Canada) countries.

- This reflects both faster projected GDP growth in the E7 economies and the systematic tendency of banking sectors to grow faster than GDP as these economies develop.

- Its projections suggest that India has the potential to be the fastest-growing large economy in the world as we approach the mid-century, followed by Indonesia – both ahead of China, due in particular to their less rapidly ageing populations .

- This implies that global banks that do not develop strong positions in India & other E7 economies will find it difficult to maintain the same growth rates of assets and profits as those that do.

Thank you.