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Indian Banking Sector

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Role of changing banking landscape

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Foreword

With a positive consumer outlook, financial services are set for a new path. Though, the economy is yet to feel the positive impact of the new entrants in the banking sector, the feeling of euphoria lingers on with the regulator's decision to offer banking licenses on tap and differentiated licenses to the hopefuls.

Increasing the number of banks could meet the agenda of financial inclusion which is the need of hour in the banking sector of 'Land of rising sun'. As is observed from the content in this white paper, as of December 2013, the North-Eastern region recorded the lowest credit-deposit (C-D) ratio of 35.6 per cent as against the pan-India average of 76.9 per cent indicating inadequate inclusion. We have discussed few recommendations in this paper to help improve the penetration in the financial sector.

In an ever evolving industry, it is important to harness the opportunity at the right time. Banking leaders have to understand the current trends and the future ones that will likely shape the industry in terms of technology, business models and consumers, and then manoeuvre their businesses accordingly. Technology (social, mobile et al) is now given, but can innovation be taken for granted?

2014 could see unprecedented growth in terms of innovation in financial services. Industry players could look at innovative business models in an attempt to ensure margins and productivity, be more customer aligned, both in thoughts and actions, and could aim to follow leading industry practices in the banking industry. This report covers eight disruptive innovations around customer centricity such as digital drive, e-zone branches, Know Your Customer (KYC) data warehouse, payments, mobile coup etc. that could change the face of the Indian Banking sector.

One of the major concerns in the banking sector is that deteriorating asset quality could persist in FY 2014-2015 if steps are not taken by the banking industry in the right direction. Currently, the gross non-performing assets of the Indian banking sector is approximately INR2.5 trillion. Bad assets and restructured assets in total is around INR8.5 trillion, or 14 per cent of total loans in the banking industry[1]. The asset quality may put pressure on a bank's profitability and capitalisation in the near future if action is not taken immediately.

This white paper is a result of KPMG in India's and ICC's hard work and brain-storming sessions on strategies and themes for the Indian banking sector. KPMG in India has given few recommendations for improving the banking climate in the Eastern and North-Eastern regions. We hope you find this report useful.

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1. http://www.livemint.com/Opinion/TyDPBETWxNozS3LiuBWifM/Three-challenges-before-the-new-FM.html, 25 May 2014

Indian banking sector

At a focal point

After a strong growth phase during 2000-2008, the last five years witnessed a change in the growth trajectory of many banks. We have observed that, while some of the banks went into a consolidation drive, others chose to calibrate their exposure to certain segments. An economic slowdown combined with the after effects of the global financial crisis, stringent regulations and the government's inability to adequately fund public sector banks (PSBs) seems to have cast a shadow over the high growth of the Indian banking sector.

Declining profitability of PSBs

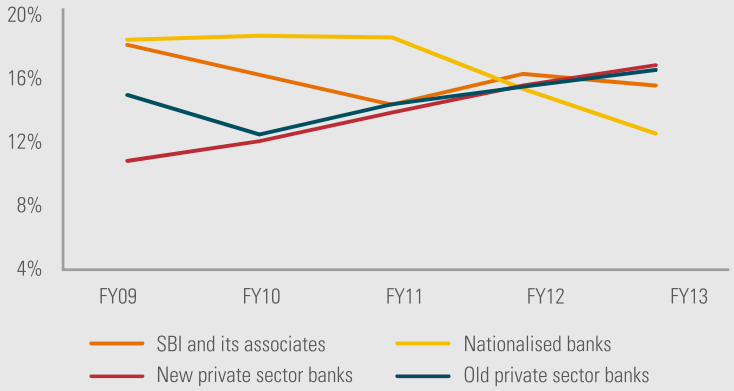
There has been pressure on PSBs to be competitive and improve their profitability but they have been lagging behind their private counterparts. In fact, the last five years were watershed years for PSBs in terms of deteriorating profitability as reflected in their Return on Equity (RoE) and Net Interest Margins (NIMs). The RoE for nationalized banks in FY13 was 12.34 per cent as compared to 16.51 per cent of new private sector banks as reflected in the RoE of banks table.

RoEs of nationalized banks have fallen significantly in the last five years from 18.05 per cent in FY09 to 12.34 per cent in FY13. The story is different for new private sector banks in which case the RoE has increased tremendously from 10.69 per cent in FY09 to 16.51 per cent in FY13.

Net Interest Margins (NIMs), another key indicator of profitability, has been almost stagnant for nationalised banks since FY09, but it has improved from 2.88 per cent in FY09 to 3.30 per cent in FY13 for new private sector banks. In fact, NIM has fallen sharply from 3.25 per cent in FY12 to 2.98 per cent in FY13 for SBI and its associates, while it has increased for new private sector banks.

RoE of banks, FY13 (in per cent)

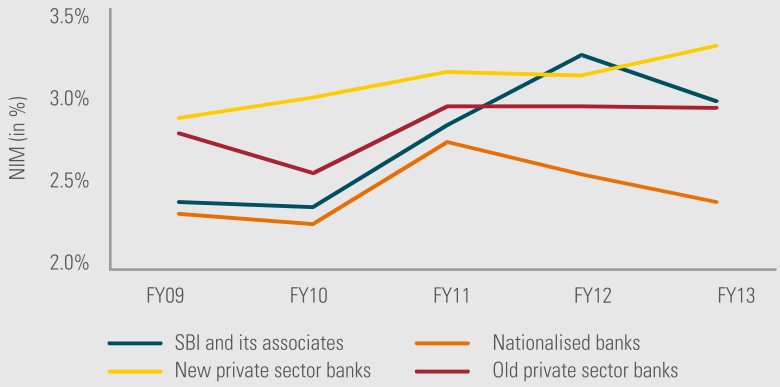
Year	SBI and associates	Nationalised banks	New pvt. sector banks	Old pvt. sector banks
FY09	17.74	18.05	10.69	14.69
FY10	15.92	18.30	11.87	12.29
FY11	14.11	18.19	13.62	14.11
FY12	16.00	15.05	15.27	15.18
FY13	15.29	12.34	16.51	16.22



Source: A profile of banks 2012-13, Reserve Bank of India

NIM of banks, FY13 (in per cent)

Year	SBI and associates	Nationalised banks	New pvt. sector banks	Old pvt. sector banks
FY09	2.39	2.32	2.88	2.79
FY10	2.36	2.26	3.00	2.56
FY11	2.84	2.74	3.15	2.95
FY12	3.25	2.55	3.13	2.95
FY13	2.98	2.39	3.30	2.94



Source: A profile of banks 2012-13, Reserve Bank of India

There could be varied reasons for low profitability of PSBs such as increased costs, NPAs and restructured assets, and stringent regulations. The below section discusses the reasons in detail:

1. High cost of operations

PSBs lag behind their private counterparts in terms of managing their costs which is reflected in the former's high cost-income ratio. It has increased from 45 per cent in FY12 to 48 per cent in FY13 for SBI and associates, while it has decreased from 46 to 44 per cent for the new private sector banks.

Cost-Income ratio (in per cent)

	SBI and associates	Nationalised banks	New pvt. sector banks	Old pvt. sector banks
FY12	45.18	42.88	46.16	49.77
FY13	48.18	44.05	44.76	49.03

Source: KPMG in India analysis in FY13; Annual reports of all SCB for FY13

Wages as per cent to total expenses

	SBI and associates	Nationalised banks	New pvt. sector banks	Old pvt. sector banks
FY09	15.06	13.31	10.17	13.26
FY10	17.10	13.65	12.10	14.57
FY11	19.97	16.41	13.83	16.75
FY12	17.42	12.20	11.97	13.00
FY13	16.20	11.81	11.40	12.28

Source: A profile of banks 2012-13, Reserve Bank of India

We have observed that, one of the prime reasons for increased costs has been the large proportion of expenditure on workforce. Though the wages cost has decreased for the nationalized banks from 13.31 per cent in FY09 to 11.81 per cent in FY13, it has increased from 15.06 per cent in FY09 to 16.20 per cent in FY13 for SBI and its associates. PSBs are essentially grappling with a 'missing middle layer' in their workforce on account of hiring freeze for a long time. A huge component of retirement benefits associated with legacy policies is another significant component increasing the overall employee cost. We have seen that, PSBs' costs have also increased on account of spending on hiring and grooming people to replace significant retirements.

It is also essential for PSBs to re-skill and re-deploy their existing workforce to increase productivity which is still low as reflected in profit per employee for PSBs as compared to the private sector banks. A four year CAGR for PSBs (nationalized and SBI and its associates) has been in the range of seven to eight per cent, while it has been 18.92 per cent for new private sector banks.

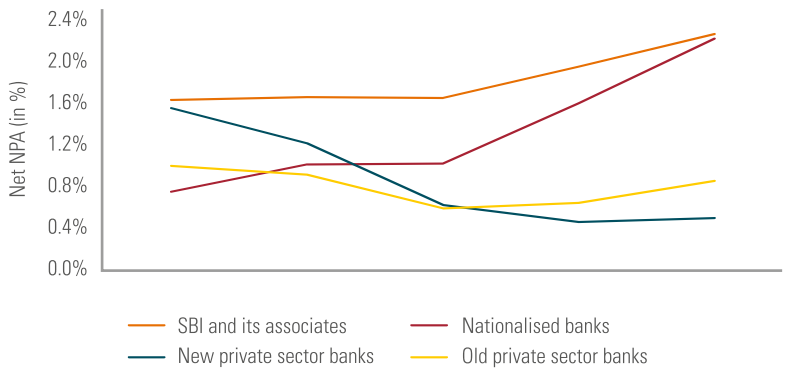
Profit per employee (in INR '000)

	SBI and its associates	Nationalised banks	New private sector banks	Old private sector banks
FY09	442.88	485.54	590.00	469.22
FY10	466.33	567.06	810.00	420.05
FY11	418.63	700.36	900.00	560.00
FY12	550.00	690.00	1,010.00	630.00
FY13	600.00	650.00	1,180.00	750.00
CAGR	7.89%	7.57%	18.92%	12.44%

Source: A profile of banks 2012-13, Reserve Bank of India

2. Increased bad debt and restructured assets

There has also been a sharp increase in Net NPAs for SBI and other nationalised banks since FY09.



Source: A profile of banks 2012-13, RBI.

Stressed loans in India (bad and restructured) crossed 10 per cent of all loans in mid 2013-14 and are expected to touch 15 per cent by the end of 2014-15.[1] Given the alarmingly high bad and restructured assets, many banks have become wary of lending to certain sectors such as aviation and real estate, as they feel that they would be grappling with the risk of deteriorating asset quality in the future. Banks need prudent provisioning to balance risk and returns as good asset quality can be an indicator of a stable and a profitable bank.

We have observed that, growth in bad debt has been primarily driven by corporate and SME credit, which accounted for majority of the growth in the NPAs. On the other hand, segments of retail saw a reduction in NPA levels with the use of credit information bureaus. Such approaches like deploying information and data analytics are missing in corporate credit. Increase in NPAs in the banking sector could impact the asset portfolio, interest income, profitability, and cost of funds and the end result could be an impact on the competitiveness of the banking sector along with capital erosion.

The RBI proposes to gradually increase the provisioning requirement on new standard restructured accounts in a phased manner to 5 per cent by FY16 from 2.75 per cent in FY13 as depicted below. Increased provisioning on restructured standard assets is a good measure in the medium- to long-term as banks' profit margins can be protected against sudden increase in NPAs, losses, etc.

1. http://articles.economictimes.indiatimes.com/2014-05-04/news/49609455_1_asset-quality-banking-sector-cii

Provisioning requirement on new standard restructured accounts

We believe that both the banks and the regulator have to work hand-in-hand to help ensure that the banking sector is not plagued with bad assets. Banks have to improve their due diligence, enhance technical capacity, improve credit appraisal and constantly monitor the loan disbursements while the regulator has to revamp the corporate debt restructuring (CDR) mechanism, and improve the effectiveness of insolvency regime. Banks management should also see the operational turnaround of restructured assets. There should also be a mechanism to collect credit data and establish a central repository that lists down large exposures.

Source: www.rbi.org.in

3. Regulatory norms

With upcoming Basel-III norms, PSBs could be under further pressure for profitability and may struggle to improve their RoEs as there is a need for higher capital requirement due to credit provisions and write-offs; but the government may not be able to infuse further capital to meet the norms. Banks need to comply with the capital regulations by 31 March 2019.

PSBs can be a dominant force for financial inclusion

While releasing the discussion paper on new bank licenses, the RBI[2] said "It is generally accepted that greater financial system depth, stability and soundness contribute to economic growth. But beyond that, for growth to be truly inclusive requires broadening and deepening the reach of banking. A wider distribution and access of financial services helps both consumers and producers raise their welfare and productivity."

We have seen that, PSBs have been a dominant force in extending the financial inclusion but it would be unfair to expect PSBs to take all the onus of financial inclusion considering the vast geographical areas. The issue of financial exclusion assumes all the more importance in the eastern and northeastern region of the country given the relatively weaker technology and physical infrastructure of the region.

Strong PSBs could give the required impetus to the economy

PSBs dominate more than 70 per cent of banking assets in the country and hence, any weakness in the system could be detrimental to the Indian financial services sector in particular, and to the economy on the whole.

Public sector banks will likely have to overhaul their complete operations in an attempt to ensure that they reach the 16 to 18 per cent RoE orbit.

Banking scenario in the Eastern and North-Eastern (NE) region

As of December 2013, the NE region recorded the lowest credit-deposit (C-D) ratio of 35.6 per cent as against the pan-India average of 76.9 per cent indicating inadequate inclusion even among those using banking services. In terms of branches of SCBs, while the Southern region accounts for approx. 28 per cent of the total number of bank offices, the NE region accounts for only 2.6 per cent of the offices. The scenario is also not good when it comes to the penetration of other financial services offerings, such as insurance and mutual funds.

Region-wise business and network of SCBs

S. No.	Region	All scheduled commercial banks			
		Offices	Deposit	Credit	C-D ratio
1	Northern region	18.1%	20.6%	23.0%	85.8%
2	North-eastern region	2.6%	1.7%	0.8%	35.6%
3	Eastern region	16.0%	12.4%	7.6%	47.2%
4	Central region	20.0%	12.4%	7.5%	46.5%
5	Western region	15.4%	30.7%	33.8%	84.6%
6	Southern region	28.0%	22.2%	27.3%	94.7%
	All India	100.0%	100.0%	100.0%	76.9%

Source: 'Quarterly Statistics on Deposits and Credit of Scheduled Commercial Banks,' Reserve Bank of India website, accessed on 14 May 2014, http://www.rbi.org.in/scripts/QuarterlyPublications.aspx?head=Quarterly Statistics on Deposits and Credit of Scheduled Commercial Banks

2. http://www.rbi.org.in/scripts/bs_viewcontent.aspx?Id=2260

Few recommendations to improve financial penetration and maintain profitability in the North-eastern region

Just like any other region, North Eastern India and Eastern India are distinct in terms of their challenges and opportunities. Almost every department of the central and state governments have provided special benefits to companies operating in these regions. The Reserve Bank of India took various measures to help ensure financial inclusion but collectively lot more needs to be done. We have seen that, the key sectors that drive employment in these regions are mining, textile, leather processing, tourism, cement, agriculture, steel, etc. It is essential that financial institutions find mechanisms to tie up with organizations to innovatively take the inclusion agenda forward. Banks and companies should look at spending the mandated CSR amount in a way that works towards overall development of the region. Banks should also leverage the finance functions of these organizations to further distribute financial products.

Also, lot of people from various villages have migrated to metros and neighboring areas in search of better working opportunities. We have observed that, many people from villages from states like Bihar, in East India, have migrated to cities in the National Capital region, Gujarat and Maharashtra to mainly work in the ship breaking industry, hotels, private taxi services etc. They usually remit their earnings back home to their villages. Some also take small loans from banks and pay for their EMIs through their earnings. Many have started to open bank accounts in home branches to remit money, however, due to limited penetration of bank branches in home locations, members of family have to travel far distances to withdraw money. Currently, majority of the households receive income through remittances from migrant labor and utilize these funds as additional sources of funds to engage in farming activities, and some take loans from government co-operatives secured against the farming produce.

As quoted in the RBI's 'Report of the Committee on Financial Sector Plan for North Eastern Region' in 2006, the main factors that impede banking and financial development in the NE region are the topography of the region, sparse settlements of population, infrastructural bottlenecks such as transport, communication and power, low level of commercialization, lack of entrepreneurship, development strategy based on grants rather than loans, and low network of branches. Based on the issues, **KPMG in India recommends the following action points:**

What the Government needs to do

The Union Government and the State Government along with the Ministry for the Development of the North Eastern Region (DoNER) is doing its best to restore the title of 'Land of the rising sun'with respect to the financial sector in the NE region. However, a lot still needs to be done.

- The government needs to increase the investment in the physical and social infrastructure and create an environment for growth and private sector investments. Providing thrust to important sectors such as manufacturing could give a boost to the region's economy and increase employment in specific sectors such as SMEs.
- There is an urgent need to complement banks' efforts with support infrastructure, such as spreading the reach of credit bureaus and credit rating agencies (CRAs), increasing the penetration of mobile banking and biometric cards, and putting in place a national identification system. The government should provide an ecosystem for the success of mobile banking and biometric cards.

What the regulator needs to do

- Improve financial literacy through collaborative efforts of various stakeholders along with the regulator; they could put in place an enabling ecosystem to enable people to achieve and sustain improved standard of living for meaningful inclusion to take place. Financial concepts should be included in the school syllabi and offered as specialised courses at colleges in the North-Eastern regions. Besides fund spent by regulator and policy makers, it would be worth considering a common pool of funds contributed by various banks, NBFCs and MFIs, and managed by an independent association to promote financial education.
- Help ensure that rural banks, self help groups (SHGs) and MFIs share information on their borrowers with credit bureaus. The outreach and capacity of CRAs should also be strengthened to serve the increasing number of MSMEs seeking bank credit.
- Implement regulatory initiatives to support growth of the sector such as constitute expert groups to recover loans to help ensure low NPAs.
- The regulator could also look at few international experiences of managing bad assets. For example, the Philippines government established the Special Purpose Asset Vehicle Law in 2002 to deal with the significant build up of NPLs. Under the law, banks could receive certain tax exemptions and fee benefits by transferring their bad loans to privately-owned asset management companies or SPVs.[3]

What the banks need to do

- Banks could look at changing their business model, for example the way a loan is reviewed could be re-looked at. In areas where restrictive mortgage loans apply, banks could use the help of Panchayat heads to help ensure clearance of loans, and may be also offer lower interest rates to priority sectors, NGOs and self-help groups to help increase the CD ratio.
- Consider offering customised and flexible financial products for the local population.
- Help with the funding of few pending infrastructure projects through SPVs to accelerate economic growth.
- Banks could also look at local community based organisations (CBOs) such as Village Development Boards to act as business correspondents to reach out to consumers in far flung areas, as branch expansion may not be a viable option.
- Deploy technology effectively to lower down costs and facilitate offsite banking.
- Build a low-cost operating model; recently the RBI has given license to Bandhan Financial services, India's largest micro-finance company with a borrower base of 52 lakhs. The aim is to further reach the unbanked areas as they are already present in 22 states with a network of 2016 branches. Giving a license to Bandhan would promote financial inclusion as currently 80 per cent of their operations are in rural areas (out of which 45 per cent is unbanked). But to maintain profitability, new and old banks need to build a low cost operating model, for example a hub and spoke operating model can help in reaching out to different segments effectively. A lean setup could be maintained at spoke locations (small branches and touch-points) while maintaining the critical functions at nearby hubs (full service branches).[5]
- Data analytics is another upcoming technology area which holds huge potential for banks to achieve the level of excellence in productivity. As per the NASSCOM and AbsolutData Research and Analytics paper titled, 'Marketing Analytics - An Opportunity for India to Lead,' the Indian marketing analytics industry is expected to grow at a CAGR of 25 per cent from USD 200 million in 2002 to USD 1,200 million by 2020.[4] Data analytics could enable banks to draw insights from huge amount of data to better establish customer identity, manage credit risk effectively, detect and prevent frauds, and maintain customer relationships among others.
- Data analytics could also help manage asset quality which is currently a prime concern for many banks in India as it could analyze the credit worthiness of customers using the data available with banks as well as the data from credit bureaus. Successful use of analytics usually depends on the effective management of huge data from multiple sources and that is where the role of big data comes in. Storing and synchronizing huge data from a multitude of sources-structured (data in customer forms, transactions, account history, etc.) as well as unstructured (data from social media sources)-is a task which requires significant investment and commitment from banks' management.

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3. KPMG's International document on Global Debt sales from Portfolio Solutions Group
4. Smriti Sharma, 'NASSCOM: Analytics Business in India to Grow to $1.2B by 2020,' 7 September 2012, Global Services website, accessed on 16 May 2014, http://www.globalservicesmedia.com/global-services/analysis/22069/nasscom-analytics-business-india-grow-usd12b-2020
5. KPMG in India analysis 2014


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Disruptive innovations

Need of the hour

Financial services in general and banking in specific have transformed multiple times over the past century. From cross country trade and merchant banking to retail banking and payments, innovation was a key trend throughout.

The Indian banking industry has been at the cusp of Innovation: Innovation in products, processes, distribution, payments, and customer service have helped banks grow significantly and become more efficient. With technology potentially being the back bone of the banking system, the next decade of Indian banking could see some significant Innovations which could make Indian banks better than some of the best banks in the globe across all parameters.

KPMG believes that there are eight disruptive Innovations around customer centricity, which could change the face of Indian Banking significantly if implemented to their full potential.

Digital drive: Digital Channel can change the rules of the Game for sales and service

In the Indian context, within a span of 15 years there have been significant number of changes from manual ledgers to computerisation, core banking, ATMs, Internet banking, kiosks, SMS banking, telebanking and mobile banking. Some of these have lured customers away from the physical to the digital channels

The new generation may not want to waste time visiting bank branches, or probably will not have the patience to speak to customer service executives. They would want to do banking at their convenience. With the emergence of smart phones, mobile revolution seems to have changed the face of a rural banker as well. It has possibly given the consumers in rural India a power of connectivity at their doorstep at a time when branches could not establish their footprints in those areas. Hence, we believe that there may be further tectonic shifts in consumer migration towards digital channels.

KPMG believes that in the future every kind of service would be delivered to customers across digital channels with the only exception being the inevitable lockers. Many customers of private sector and foreign banks are already on board. Private sector players can also increase their benefits of riding on a digital world. With challenges on the Return on Equity, PSU banks will likely be forced to lower the cost of transactions and migrate people to alternate digital channels. It may be inevitable. Public sector banks can conduct massive education and awareness programs to use ATMs, kiosks and mobile phones.

There could be initial incentives to drive customers to digital. One way could be to do an activity based costing of the branch channel and pass on the actual costs for service to the customer and offer the service free of cost on the digital channel, which could help ensure customer migration over a period of time. Branches could have more front desk executives at the kiosks, facilitating customers with self-service, than at the counters. Social networks can be extensively used to post any cold experiences of customers and that battalions would be required at the bank's back end to negate the NEWOM (negative word of mouth). Leadership teams should be on their toes to help ensure their reputation in social media is not

tarnished and that the media and competition do not take advantage of bad publicity.

The whole digital drive could mean lower costs and more predictability in transaction volumes and lesser loading of daily transactions on technology systems. An engaged customer means a long-term working relationship. Self-service transactions by customers can result in the banks passing on the responsibility of data entry errors to customers, and finally customer complaints could come down. With the developments, customers will likely feel that their bank cares as they are being heard.

Payments unleashed: Digital payments can be the preferred channel for money transfers

In the late 90's, cash and cheques were the only two key modes of payment. Now in 2014, with multiple payment options like RTGS, NEFT, etc. the transformation in payments space is continuing to be enormous. Usage of physical cash and its circulation has significantly come down.

We have observed that, RTGS and NEFT are the major transporters of funds in India today and IMPS is catching up at lightning speed. Consumers were once excited about the mechanism of RTGS that happen through branches, and later experienced the power of it through internet banking. Now RTGS and NEFT are at fingertips through mobile. Pay orders and Demand drafts have already achieved their salvation and might superannuate like telegram. Cheque truncation by the RBI through the grid based approach helps money flow faster, unlike the past where each city had a clearing time & zone, thus releasing locked float into the system. Truncation and At Par checking had already taken over the old ways of paper processing and sending the instruments through post to the payee bank. We feel there is more to happen in the payments space

KPMG believes that over the next decade, there could be a significant reduction in volumes of cheques, pay orders and demand drafts. RTGS and NEFT may work round the clock like IMPS and an increased number of retail payments may be done through the mobile phones. Very few people may carry cash.

Let us imagine a visit to a salon and the after service, customers will likely have the option to pay through a mobile application directly to the salon owner's bank account. SMS confirmation on both ends acknowledge the payment and receipt and the customer walks out with no more physical cash to exchange. Assume one gets into a city bus, flashes ones mobile at the entry and exit points and the bus fare is transferred from the passenger bank account to the transport company. These are the new and emerging modes of payment but there could be many more options for customers in future with the innovations around wearable technology like Google glass and iwatch. RBI's payment vision clearly indicates that the economy should reduce the use of physical cash. For this purpose, RBI facilitated the creation of NPCI and is

now proposing specialized payments bank. We feel that, 'Giro', the newest payment entity shall soon be a reality aggregating the billers and unifying the mechanism of payments induced by payer to payee. Finally, any advancement in payments should benefit a large section of migrant workers across different metros. Migrant workers tend to frequently send, small amounts to their family members and the innovative mechanisms could make this fee nearly zero.

In our view, Giros could bring in a lot of efficiency in the payer induced payments throughout the payment life cycle. Advanced economies in Nordic have even the smallest of the payments made through cards. They believe it is hassle free, secured, fast and cheaper compared to the use of physical cash.

Mobile coup: Mobiles could take over as a preferred channel for banking

The delta change over the last 15 years in India in Banking had been significant. We see transformation in the way banking is done from physically visiting a branch to experiencing banking at your door-step; the expectations of consumers have increased phenomenally. Mobiles could play a huge role in meeting the expectations.

KPMG believes that in the future, with the increase of smart phones and mobile users, banking mobile applications can be so disruptive that they could be in a position to authenticate an individual face, finger print and iris. They may also be in a position to authenticate any chemical alterations and fraud done on paper. Mobile applications will likely be integrated with core banking and signature verification might happen instantly. Any data/document scanned through a mobile application might use character recognition and data entry done automatically in the core application. With these capabilities, a new customer could be in a position to open an account by entering details, take a picture of himself, show his iris and face, scan his identity and address documents instantly which get converted and gets plugged into the core banking application. The customer may get a code over phone through which he would be in a position to visit the ATM to print his deliverables and start using banking facilities. The future ATMs might not have screens. Mobile phones that use encrypted SIM cards could be connected to the ATMs over wifi /Bluetooth/any other network. Transactions could be securely done through the customer's mobile phone connected to the ATM for cash withdrawal, printing of deliverables, etc. Mobile application, instant authentication and GPS locations based tracking could do every life cycle activity for a customer from his place.

Once technology is deployed, the rediscovered and reengineered processes could create huge service cost benefit to customers.

KYC Data warehouse: National KYC Registry to likely complement the current verification process

The days of banking with basic KYC documentation may have been much simpler. Then came the era of mass banking, centralisation of activities across locations, and with increasing volumes regulators felt the need for enhanced know your customer verification requirements. Today, knowing the customer is more important than banking with the customer.

KPMG believes that the way in which KYC is done and evaluated shall undergo a tremendous change. SWIFT took steps to create a centralized KYC registry for customers across nations. Objective of this was to reduce KYC related costs, increase efficiency and effectiveness of KYC related activities. The Reserve Bank of India also indicated that a National KYC Registry could be institutionalized if banks complete the 'unique customer identification code' process. Having a KYC registry could enable financial institutions to access the same data for onboarding or verifying a customer. The RBI also allowed Aadhar to provide e-KYC service to banks for onboarding customers. Aadhar database contains every individual's photo, details of identity, fingerprints, face & iris and address. Banks may use this database for onboarding and authentication. With these features, KYC could be much stricter and much easier to perform, while also synchronizing the data for a customer across banks. The KYC module might be centralized across banks outside a single bank. With the advancements in mobile application technology, Customer's identity, location, etc. are continuously known to the banker. And like in advanced economies, a photograph might no longer be required. These days, it typically takes just an hour for Indian police to track, identify and apprehend any individual, anywhere in India. So we are up for an integrated, wide-ranging and dynamic know your customer mechanism in the times to come.

Banks often invest a lot of time and resources in the KYC process (scrutiny, pre-audit, post-audit, etc) throughout the relationship duration. If the above mentioned is implemented, efficiencies could be improved significantly and most importantly, accuracy of information will likely get enhanced to near perfect stage.

E-zone branches: Physical channels could have reinforcements from the backend

Consumers rarely visit private and foreign bank branches. Though PSBs have taken steps to reduce footprints in the branches by setting up ATMs and internet banking, still visiting a PSU branch is a norm as they lag behind in few technological advances.

Many banks have a back end set-up with a battery of staff working at offsite locations ready to assist customers, but incoming loads hardly justify the working hours. This peculiar situation of heavy demand onsite and heavy capacity unutilised offsite with the factor of increasing attrition, etc. provides a distinctive opportunity for banks to service customers through a hitech, low cost, stable and consistent mechanism.

KPMG believes that in future when you visit a branch, you may find more interactive kiosks, you may start operating the user friendly machine and you could be connected over video to your banking assistant. Technology could help you to speak with your banking assistant, explain your problem, get details, provide all required information and the banking assistant could solve your problem. You could probably show any required documentation to the banking assistant for further verifications and finally service could be done. This can also be implemented for rural customers with some education, user friendly user interface on machine and a high speed internet connection. This ezone concept may be used as surrogate in contact centers and telephone banking. Customers feel more connected and comfortable interacting with a banking assistant rather than a faceless voice of an individual guiding over the phone. Skype and other video chat application could be integrated with banking mobile applications. Going forward, all required authentications could already be considered done if the customer initiates a call through a mobile application. At least the privilege and wealth management customers could experience this immediately as the change in relationship managers is the most frequent transaction.

Customer transactions through front office executive are often most expensive and if it can be substituted with an offsite assistant, it could help save significant cost. This also could improve service quality as attrition and learning curves will likely be negated by the offsite model. Customer retention can be improved and connected conversations could enable deeper relationship with customers and better business and profitability for banks.

Sales transformation: Technology adoption by sales and owning the fulfillment

We have observed that, over the years, banks changed from just being a fulfillment and service organisations to full-fledged sales and investment destinations for Indian customers. Public sector banks had limited sales structures before a decade and over time they got established. During those times PSBs worked in the defined locations with basic products, typical relationships and simple advances. Once private sector banks started aggressively reaching out to customers with sales personnel, PSBs too created sales teams.

Having traditional sales teams are proving to be costly tasks throughout the life cycle of a product sales and service. In one of KPMG in India's study, it is concluded that 70 to 80 per cent costs for opening a savings account are on account of acquisition. Sales teams are often running to acquire customers and in the process, they source documents and hand them over to the front office of their bank branch for further scrutiny and processing. It is most important that banks leverage sales team for more than just document sourcing; they could help acquire the right customer with the right quality of documentation and a brand ambassador.

KPMG believes that in the future, sales channels will likely prove to be one of the most important in terms of getting the right customers while helping assure quality. Future sales executives may use high technology and connectivity to engage customers throughout the sales process. Technology applications could let the sales team know which houses in a location are banked through their banks, what products are selling more in that location, what type of customers reside there and many such attributes. Sales managers could know the work, efficiency and effectiveness of their executives by various patterns. They could be in a position to know executives travel, leads, conversion stage and value of business instantly so that course correction is immediate. Future sales teams could have technology and communication that could take customer attributes and suggest the right product variants, complete the onboarding formalities, log the relevent customer information through a handheld device and close the sale and onboarding. They may be in a position to scan the collected documents, take a photo through a tablet, get the data entered and handover the deliverables

Transformation in sales organization could bring profitability, help reduce cost for sales and service, provide ready reckoner dynamic advice and support and enable first time right for key customer data.

Data analytics: Analytics could be the brain to bankers

Analysis of customer's requirement through intuition or at most through an excel sheet, was a tool implemented to find what new could be provided to customers. Banks tried segmenting customers and offered segment specific discounts, coupons or benefits based on assumptions. Energies were driven through the relationship manager (who changed frequently), branch manager and contact center executives. In fact, there are very few banks which do holistic analysis of customers need and requirement through the customer life cycle.

KPMG believes that Analytics in banking could be the next big area of expenditure and the real big opportunity for consultants and technology application providers. In the future, banks may challenge the concept of segmentation and create a 'Segment of one'. Analytics could help understand the customer's interests and needs based on their purchases, locations visited, frequency of transaction, seasonality, demographics, life cycle stage, travel pattern, etc, create person specific offers and make suggestions to the customer in a pointed manner. Analytics can also help banks in partnering and tie-ups with vendors. Many banks are far away from deploying this massive intelligence to banking

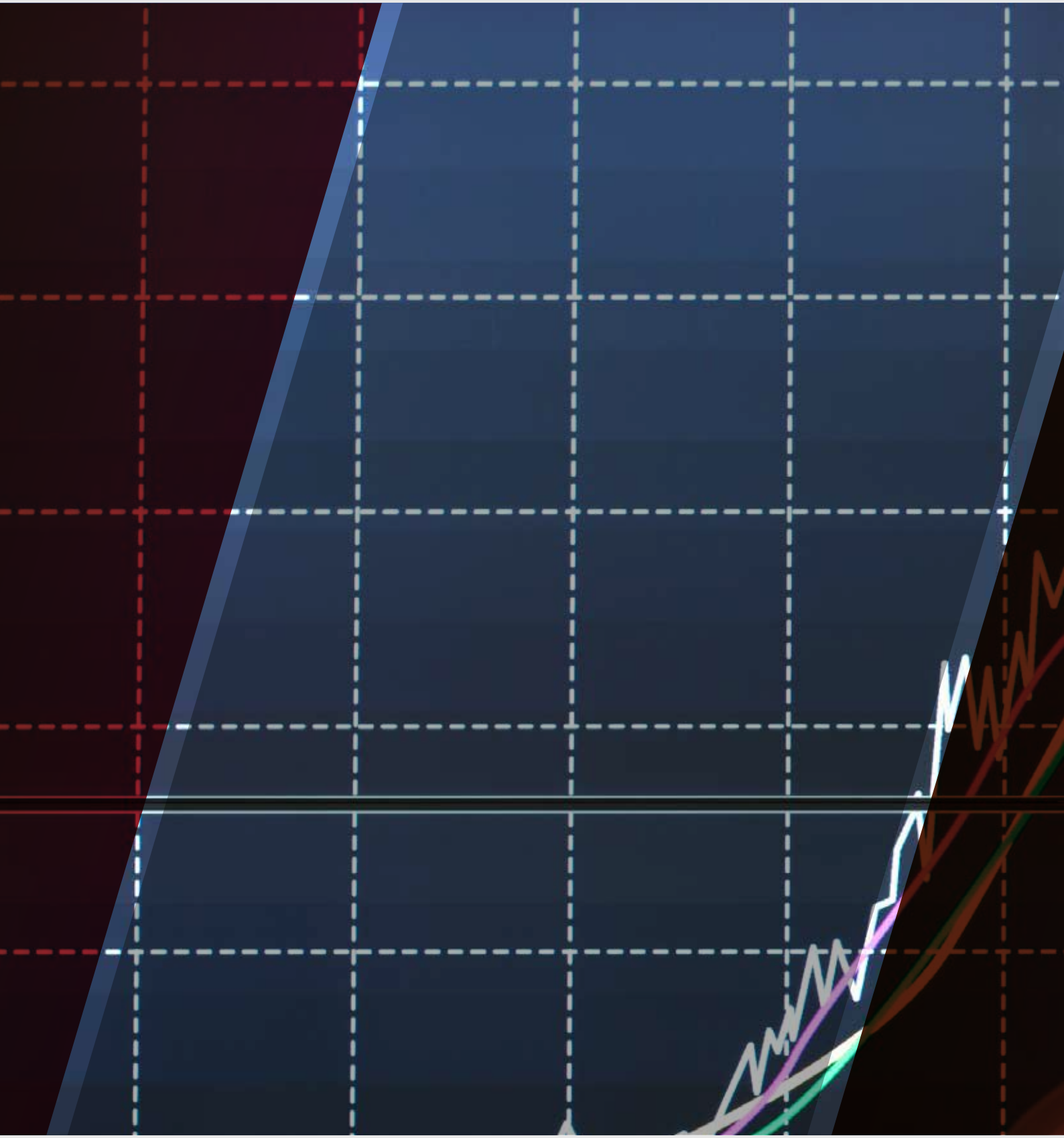
There is significant unknown and untapped potential to get closer to customers through analytics. The right product to the right customer at the the right time can help improve fee income and profits for banks.

Crushed silos: Products could be channelised at distribution locations

Over the last 15 years, we have seen that, banks fragmented a single relationship view to multiple ones such as savings account, education loan, home loan, credit card, life insurance, mutual fund, relationships etc. These were created due to the ever increasing product, process, people training and technology related difficulties. There was time before 15 years when branch staff used to advice customers on everything related to banking right from savings account, current account, deposits, agri loan and SME loans. This, however, is not the case anymore.

We have observed that, specialisations across banking products (savings, current, credit cards, agri loans, home loans, personal loans, SME loans, mid corporate, large corporate, salary accounts, cash management, forex, capital markets, treasury, insurance, investment products, trade finance, etc) created silos. While there is no question of unifying these areas and turning bank executives into super humans, there is a need for bankers to the deliver the power of a single unified approach to the customer. Many of the issues are driven due to the way a bank is structured at the corporate/head offices. It is strange however that often people at corporate offices drive the branch staff for more cross-sell and talk about a single view for the customer. In fact a number of private sector banks have banks within bank with a completely different retail structure, a completely different agri structure and a completely different business banking structure. Now imagine a single customer of this bank holding these three different product requirements.

KPMG believes that Innovation is all about the way in which certain key relationships are integrated. It is also about how the customer is insulated by the difference in the way they are treated by the banks within the bank. Each bank can have different approaches but whatever the approach is, it should ideally be initiated and driven from the top to effectively get deployed for the benefit of the customer.



Deteriorating asset quality of banks

How to overcome the challenge?

Against the backdrop of a slowdown in the domestic economy (GDP growth slipping below 5 per cent) and the moderate expansion of the global economy, we have observed that, the growth of the Indian banking sector has slowed down for the second consecutive year in 2012-13. The asset quality of many Banks has been deteriorating for the past two years as economic growth slipped to its lowest levels in a decade, while inflation and interest rates remain high. Bad debts in banks have doubled since 2009. As of September 2013, bad debts were 4.2 per cent of total loans.

Before we discuss in detail, let us review some of the latest facts and figures published/reported by the RBI[1].

- Asset quality continues to be a major concern for Banks. The Gross NPA (GNPA) ratio of Banks increased to 4.2 per cent as at the end of September 2013 from 3.4 per cent of March 2013.
- The restructured standard advances also increased to 6.0 per cent of total advances as at the end of September 2013 from 5.8 per cent of March 2013.
- Overall, the stressed advances rose significantly to 10.2 per cent of total advances as at the end of September 2013 from 9.2 per cent of March 2013. This may touch 15 per cent by the end of 2014-15, as per the CII estimate.
- Among the bank-groups, the public sector banks continue to have distinctly higher stressed advances at 12.3 per cent of the total advances, of which restructured standard advances were around 7.4 per cent.

Since, Loan and Advances are major parts of banks' Balance sheet and sources of revenue; it is inevitable for the Banks to keep check on the quality of Loan and Advances so as to remain competitive in the market. The following section traces the behavior of banks in India on advances growth and growth of GNPAs.

1. RBI's Financial Stability Report, December 2013

Bank group-wise growth in total advances

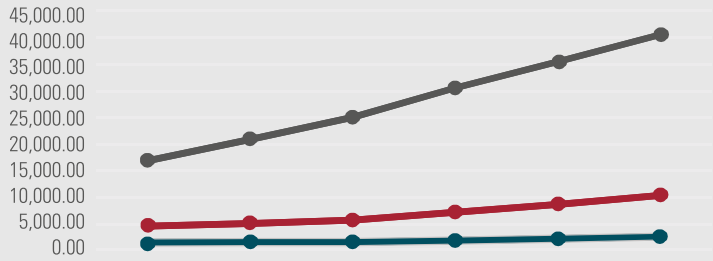
Post the 2008 global crisis, foreign banks started contracting their balance sheet world-over and the same was also applicable for foreign banks operating in India. The growth was almost flat or negative for almost two to three years. On a similar line, some of the private sector banks also reduced the pace of growth and concentrated on consolidation of the balance sheet. Contrary to this, in our view, PSU banks were aggressively lending in the market.

(INR billion)

Year	Public sector	Percentage change over the previous year	Private sector	Percentage change over the previous year	Foreign banks	Percentage change over the previous year
2008	16,961		4,727		1,630	
2009	20,986	23.74%	5,201	10.02%	1,697	4.12%
2010	25,124	19.72%	5,851	12.50%	1,674	-1.34%
2011	30,600	21.79%	7,330	25.27%	1,993	19.04%
2012	35,504	16.03%	8,812	20.23%	2,347	17.77%
2013	40,559	14.24%	10,467	18.78%	2,686	14.43%

Source: RBI Statistical Bulletin: Dept. of Banking Supervision

Total advance



	2008	2009	2010	2011	2012	2013
Public Sector	16.960.51	20.986.33	25,124.39	30,599.53	35,503.89	40,558.74
Private Sector	4,727.00	5,200.77	5,851.10	7,329.53	8,812.16	10,466.65
Foreign Bank	1,629.99	1,697.14	1,674.39	1,993.21	2,347.32	2,686.12

Source: RBI Statistical Bulletin: Dept. of Banking Supervision

Bank group-wise gross NPA per cent

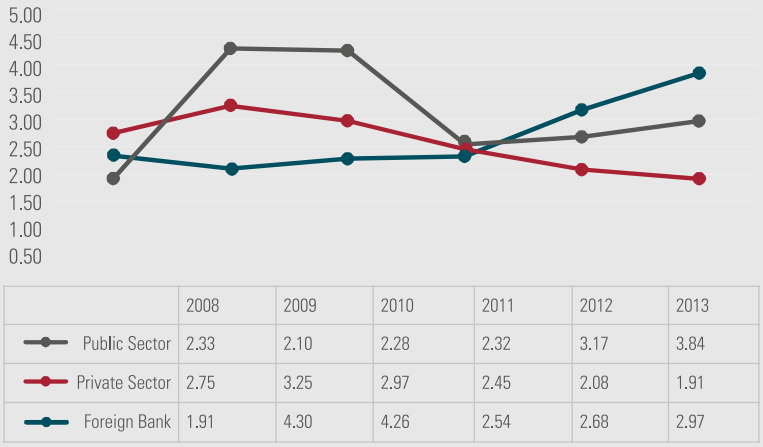
Post 2008, the Indian Public sector banks witnessed continuous increase in their Gross NPA Ratio which increased from 2.33 per cent in 2008 to almost 4 per cent by the end of March 2013. Contrary to this, private sector banks somehow managed to bring it down from its peak of 3.25 per cent (in 2009) to 1.91 per cent in March 2013. Even foreign bank operations in India were also able to reduce their GNPA per cent remarkably.

(Per cent)

	2008	2009	2010	2011	2012	2013
Public sector	2.33	2.10	2.28	2.32	3.17	3.84
Private sector	2.75	3.25	2.97	2.45	2.08	1.91
Foreign banks	1.91	4.30	4.26	2.54	2.68	2.97
All banks	2.39	2.45	2.51	2.36	2.94	3.42

Source: RBI Statistical Bulletin: Dept. of Banking Supervision

GNPAs



Source: RBI Statistical Bulletin: Dept. of Banking Supervision

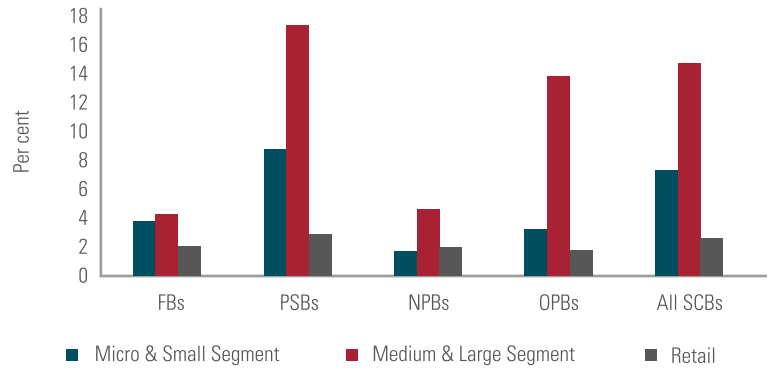
Sectors' contribution to gross NPAs

If we review the sectoral contribution for Gross NPAs the following key points emerged[2]:

- Agriculture recorded the highest GNPA ratio at 5.5 per cent as at the end of September 2013, followed by Industries at 4.9 per cent.
- Since Industries/ Manufacturing accounts for largest exposure by the banks, thus contributed the highest share of Stressed Advances loans portfolio at 15.9 per cent as at the end of September 2013, followed by Services sectors at 7.6 per cent.
- Loans under the retail segment fared much better with GNPA and restructured standard advances to total advances at 2.2 per cent and 0.3 per cent as at the end of September 2013, respectively.
- The new private sector banks, having the largest share of retail segment in their loans portfolio of around 30 per cent, seemed to have benefited in terms of better asset quality relative to other bank-groups. Public sector banks have the lowest share of retail segment in their loans portfolio, of around 16 per cent (please refer the following graph).

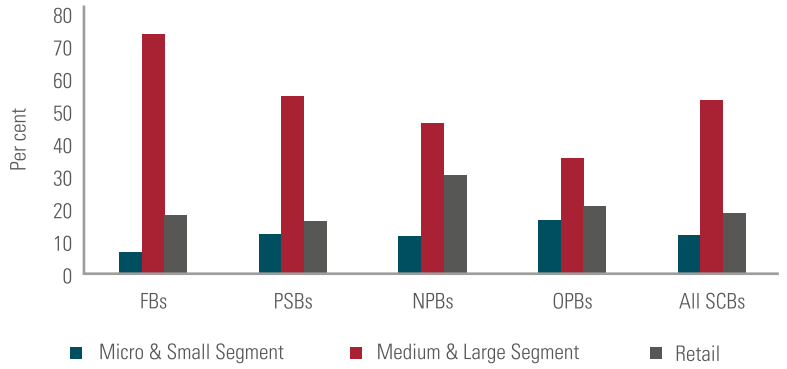
Size-wise asset quality and share: Bank-group wise (September 2013)

Stressed advance ratio



Note: Stressed Advance Ratio = Stressed Advance to Total Advance in the respective segments
Source: RBI Supervisory Returns and Financial Stability Report, December 2013

Share in total loans



Note: FBs: Foreign banks, PSBs: Public Sector Banks, NPBs: New Private Sector Banks, OPB: Old Private Sector Banks, SCBs: Scheduled Commercial banks
Source: RBI Supervisory Returns and Financial Stability Report, December 2013

2. RBI's Financial Stability Report December 2013

Let's examine what are the key differentiators among the banks for differentiated performances. The risks faced by the banks can be broadly classified into two categories viz., systematic risks and idiosyncratic risks. Systematic risk emanates from movements of macro-economic factors and market and policy environment. Faced with similar systematic risks, different banks react differently based on their strategies, risk appetite, governance framework, portfolio compositions etc. Managing these idiosyncratic risks distinguishes between stronger and weaker banks. We have observed that, stronger banks were able to maintain the quality of assets, profitability and preserve capital, whereas other banks found it difficult to manage the quality and profitability as a result erosion of capital.

Key differentiators in managing idiosyncratic risk are, developing and adopting risk culture, specialised resource for risk management, systematic approach towards risk, informed decision making based on historical data and use of technology for early warning signals, monitoring and follow ups. Banks may use a combination of above to manage the asset quality in more effective and efficient way. These can be grouped in to following headings.

Developing risk culture:

- In India, risk is typically considered as post facto compliance related activity. But in fact, risk can be a proactive and continuous process. Developing risk culture is one of the most important factors as far as modern banking is concerned.
- Risk culture can be brought in by way of proper training to staff, separating risk from the business (risk Independence) and a strong governance process

Informed decision making at the origination:

- As there is no active CDS market in India, it is difficult (apart from requesting additional collaterals) to reduce exposures on the loans once it is disbursed. At the time of taking exposure all possible information needs to be considered, which includes, financial, non-financials, risk adjusted returns and forward looking measures like stress testing.
- Risk Based Pricing (RBP) and implementation of Risk Adjusted Return on Capital (RAROC) framework. Though implementation of RAROC is data sensitive, banks may consider an option for creating data warehouse, bridging data gap, cleansing the data and making it available to the management for decision making, in particular while extending fresh loans to existing borrowers.
- While decisions are made at the account level, the portfolio impact on risk, capital and returns may also need to be considered.

Specialised resources:

- We have observed that, till the recent past risk was a part of normal banking business, but after the recent financial crises it has gained a special attention in terms of specialist officers in the area of risk management. This is mainly because of the extensive use of financial engineering products. Banks should have specialist to support risk evaluations and measurements.
- Banks when preparing to launch new products and services, could get them evaluated by the risk team from a risk perspective and solutions could be provided to reduce the same. Any oversight on the risk may cost the institution.

Early warning signals:

- Use of indicators like, stock price movements, availing of overdraft facilities, crossing industry specific thresholds, days past due, balance sheet data not updated, negative news etc. may be very useful for the early identification of risk and helps bank in getting better equipped for facing such situations.
- Framing a risk appetite: Banks should have a risk appetite statement for all major risks viz., credit, market, operational risks and Bank should be continuously measured/monitored against pre-set risk appetite. Continuous and effective monitoring of Risk appetite could help in giving early warning signal and to adopt contingency plan.
- Effective stress test program: The effective use of stress test scenarios and results along with actionable management trigger points and contingency capital plan could help banks in identifying the vulnerable portfolio at an early stage and can make banks better equipped to face stress situations.

Risk focussed audit:

- Risk focussed audit of high value advances and restructured advance could help in identification of weakness in accounts at an early stage.
- Banks may consider audit of accounts from risk point of view with respect to deviations from banks Loan policy and Regulatory guidelines, etc.
- Failure of a major corporate or a major corporate group could trigger a contagion in the banking system due to exposures of a large number of banks to such corporates.[3]

3. RBI's Financial Stability Report December 2013

Use of technology:

- IT enabled Financial systems are desirable and can help in quick decision making and in the standardisation of the process.
- Standardized and Customized Loan Origination System, Rating Platform, MIS, Early warning Signals (EWS) for NPA and dash boards can be more than useful for effective and efficient Risk management practices and decision making in Banks.
- Unique Customer Identification (UCI) across banking system can be of paramount importance. We have observed that, while some of the Indian banks have established a unique customer identification process, there is no unique identification across the banking system based on a shared database. This could enable borrowers to circumvent the risk profiling guidelines and obtain multiple facilities across banks. UCI could eventually graduate to a Legal Entity Identifier (LEI). LEis are a unique ID associated with a single corporate entity which assists in easy identification of the entity across multiple financial market utilities and aids in tracking settlement activity and exposures.[4]

To sum up banks need to strengthen their due diligence, credit appraisal and post sanction loan monitoring systems[5], use of technology enabled EWS to help minimise and mitigate the problems of increasing NPAs. It is also necessary to collect credit data and examine large common exposures across banks. This could enable the creation of a central repository on large credits, which can be shared with the banks. This in turn can help enable banks to be aware of building leverage and common exposures.[6]

Banks should have mechanism to catch signs of distress at an early stage to help ensure that NPAs do not increase. The RBI has advised banks to share information on borrowers before a loan is disbursed so that everyone is aware of borrowers who default.

The above discussed points does not necessarily assure automatic improvement in asset quality but it can help in early identification and in triggering management actions so as to revive the quality of assets before it actually turns non-performing. With the use of modern risk management technique and IT systems, banks can to a large extent proactively manage its assets quality.

However, we need to keep in mind that there are some systemic issues which play a vital role in the banking industry. These factors are so evident that individual banks may not be able to control or avoid them. Some of these key issues are changes in the government policy, delay in environmental clearances, long gestation periods in case of Infrastructure project and lack of new entrepreneurship in the SME segment, etc. With the new government at the helm, the government could try to address major systemic issues, banks are expected to have greater control over their idiosyncratic issues so that they can contribute positively in the growth of banking industry and in turn the economic growth.

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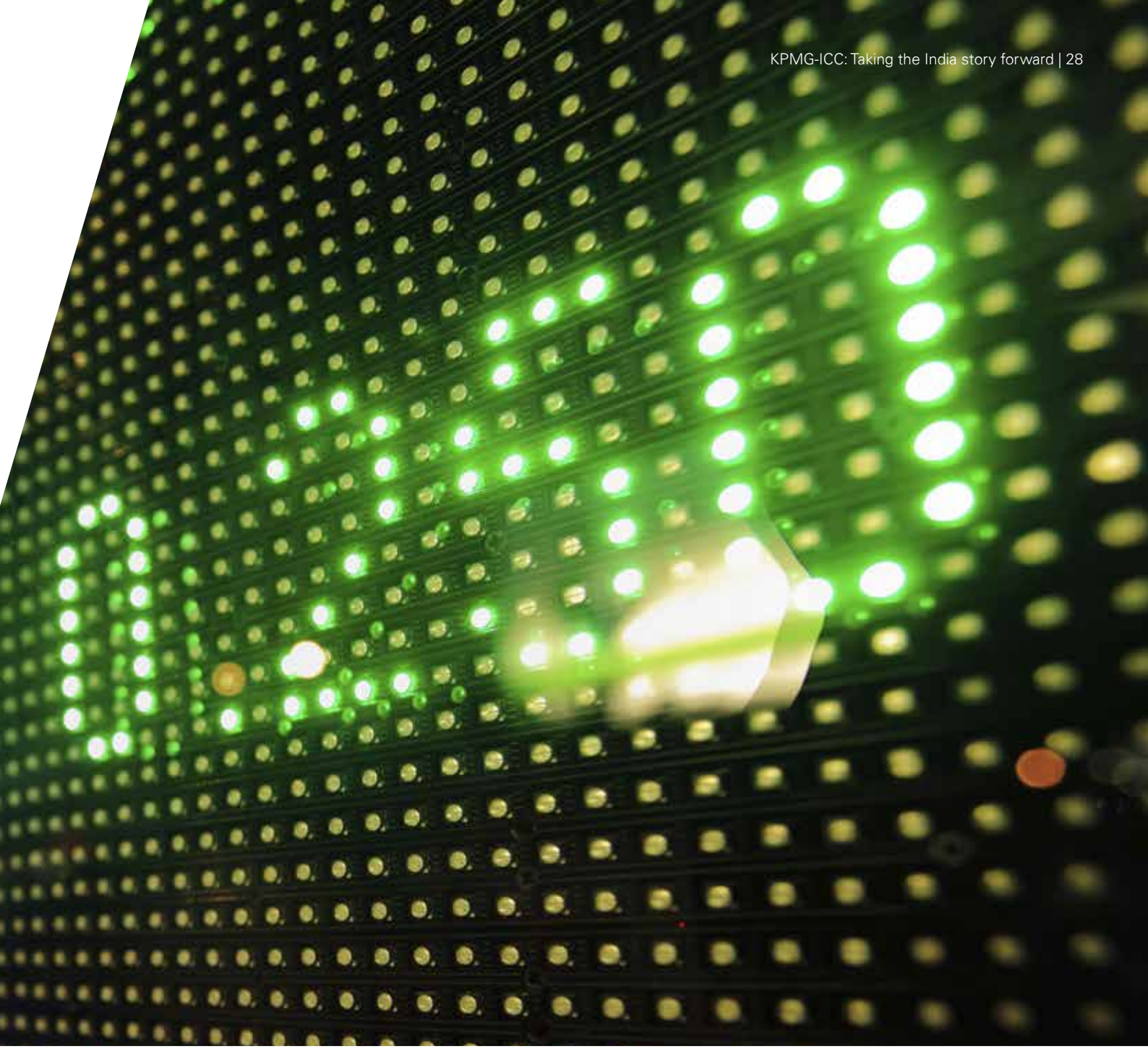
4. http://rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=676
5. http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/01RTP211113C.pdf
6. RBI's Trends and Progress of Banking in India 2012-2013



About KPMG

KPMG International

KPMG International is a global network of professional firms providing audit, tax and advisory services. KPMG member firms operate in 155 countries and have 155,000 professionals working in offices around the world.

The KPMG audit practice endeavours to provide robust and risk-based audit services that address the member firms' clients' strategic priorities and business processes.

KPMG member firms' tax services are designed to reflect the distinct needs and objectives of each client, whether firms are dealing with the tax aspects of a cross-border acquisition or developing and helping to implement a global transfer pricing strategy. In practical terms that means, KPMG firms' work with their clients to assist them in achieving effective tax compliance and managing tax risks, while helping to control costs.

KPMG advisory professionals provide advice and assistance to help enable companies, intermediaries and public sector bodies to mitigate risk, improve performance, and create value. KPMG firms provide a wide range of Risk Consulting, Management Consulting and Transactions & Restructuring services that can help their clients respond to immediate needs as well as put in place the strategies for the longer term

KPMG in India

KPMG in India, a professional services firm, is the Indian member firm of KPMG International and was established in September 1993. Our professionals leverage the global network of firms, providing detailed knowledge of local laws, regulations, markets and competition. KPMG in India provides services to over 4,500 international and national clients in India. KPMG has offices across India in Delhi, Chandigarh, Ahmedabad, Mumbai, Pune, Chennai, Bengaluru, Kochi, Hyderabad and Kolkata. The Indian firm has access to more than 7,000 Indian and expatriate professionals, many of whom are internationally trained. We strive to provide rapid, performance-based, industry-focussed and technology-enabled services, which reflect a shared knowledge of global and local industries and our experience of the Indian business environment.

About the Indian Chamber of Commerce

Founded in 1925, Indian Chamber of Commerce (ICC) is the leading and only National Chamber of Commerce operating from Kolkata, and is one of the most pro-active and forward-looking Chambers in the country today. Its membership spans some of the most prominent and major industrial groups in India. ICC is the founder member of FICCI, the apex body of business and industry in India. ICC's forte is its ability to anticipate the needs of the future, respond to challenges, and prepare the stakeholders in the economy to benefit from these changes and opportunities. Set-up by a group of pioneering industrialists led by Mr G D Birla, the Indian Chamber of Commerce was closely associated with the Indian Freedom Movement, as the first organised voice of indigenous Indian Industry. Several of the distinguished industry leaders in India, such as Mr B M Birla, Sir Ardeshir Dalal, Sir Badridas Goenka, Mr S P Jain, Lala Karam Chand Thapar, Mr Russi Mody, Mr Ashok Jain, Mr.Sanjiv Goenka, have led the ICC as its President. Currently, Mr. Shrivardhan Goenka, is leading the Chamber as its President.

ICC is the only Chamber from India to win the first prize in the World Chambers Competition in Quebec, Canada.

ICC's North-East Initiative has gained a new momentum and dynamism over the last few years, and the Chamber has been hugely successful in spreading awareness about the great economic potential of the North-East at national and international levels. Trade & Investment shows on North-East in countries like Singapore, Thailand and Vietnam have created new vistas of economic co-operation between the North-East of India and South-East Asia. ICC has a special focus upon India's trade & commerce relations with South & South-East Asian nations, in sync with India's 'Look East' Policy, and has played a key role in building synergies between India and her Asian neighbours like Singapore, Indonesia, Bangladesh, and Bhutan through Trade & Business Delegation Exchanges, and large Investment Summits.

ICC also has a very strong focus upon Economic Research & Policy issues - it regularly undertakes Macro-economic Surveys/Studies, prepares State Investment Climate Reports and Sector Reports, provides necessary Policy Inputs & Budget Recommendations to Governments at State & Central levels.

The Indian Chamber of Commerce headquartered in Kolkata, over the last few years has truly emerged as a national Chamber of repute, with full-fledged State Offices in New Delhi, Guwahati, Bhubaneshwar, Patna and Ranchi functioning efficiently, and building meaningful synergies among Industry and Government by addressing strategic issues of national significance.

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