"One of the major engines for Indian GDP growth is domestic consumption"

Uday Kotak on the wealth effect, the challenges before the financial sector and India's changing attitude to investment and spending.

The Executive Vice Chairman and Managing Director, Kotak Mahindra Bank, recently joined the Indian School of Business (ISB) Executive Board. He visited the ISB and addressed the students as well as the Capital Markets Conference. Two ISB alumni – Abhishek Memani, Class of 2001 and Sumit Anand, Class of 2005, spoke with him to get his views on the markets and the finance industry. Excerpts from the conversation:

India is perceived as a nation of savers. Is this impression changing?

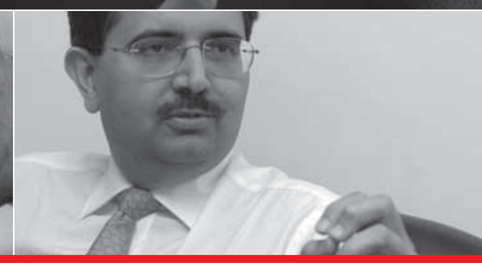
One sees the change happening in front of the eyes, almost like a motion picture. In the '80s and early '90s, the most popular savings instrument was the Unit Trust of India. When it failed during the late '90s, the RBI Tax Relief Bonds became extremely popular. To Indians, particularly after the 1992 security scandal, equity was risky and problematic. Most people had significant amount of money in savings instruments. Indians had a middle class value culture - whatever money one made was saved. The paradigm shift from a 'nation of savers' to a 'nation of investors' started 2003 onwards. Till 2003-04, equity as a portion of household savings was around 2%, a miniscule amount. In the last three to five years, we have also graduated to become a 'nation of spenders', thanks to the spread of television and mobile. We are getting comfortable with spending money and using leverage more than ever before.

Does the fact that the nation of savers is turning to a nation of spenders, have an impact when the market or the economy turns around?

That is what you call 'the wealth effect'. If you feel wealthy, you spend more. The most appropriate example is of the US homes business. From 2000 onwards, the real estate rates kept escalating and the home owner borrowed more and more. When the downturn hit in 2006, the behaviour began to change. One of the major engines for Indian GDP growth is domestic consumption. We believe that an 8% growth can be sustainably achieved by India. This requires very large consumption growth, for long periods of time.

Many of our friends are using leverage for getting into real estate and for buying stocks. What happens if there is a sharp downfall?

Leverage is a virtuous circle when things are going well and a vicious circle when things are not going well. It explodes dramatically. Because of the expansionary impact of leverage, one tends to take much higher risks - going up you make a lot of money but while going down, you lose a lot more money faster. This transformation started only three to four years ago. We are still in a wonderful Cinderella period of the good side of leverage. The question really is, how deep is the downward correction going to be? We have seen corporate India getting caught on the wrong side of leverage during the '90s. Leverage, within reasonable amounts, helps on the path to improve returns. But where does one draw the line? How does one



decide where leverage is appropriate and where it is excessive? We must keep in mind that this is a good cycle and that trees do not touch the skies.

We talk about banks and Indian financial companies going international. Is the time appropriate? Is the demand in India substantial?

The financial sector in India, undoubtedly, is one of the finest opportunities anywhere in the world. India is sitting on a significant opportunity, based and driven by domestic consumption. Internally, I have a very simple matrix for what the international business should be like:

- Indian financial instruments or Indian products for Indian customers.
- Indian products for global customers – servicing FIIs on the institutional side, or foreigners investing in Indian assets.
- Global products for Indian customers – investment banking, convertible bonds, acquiring overseas business or investing overseas.
- Global products for global customers.

At this stage we want to operate in the first three areas. These are aligned to a significant strategic integration. At Kotak, in five years, we should have 20 to 25% of our business linked to the global situation.

What are the changes you would like to see in the Indian financial sector which could give an impetus to the entire industry?

There is a need for the policy makers to recognize that the markets are integrating much faster than the policy structures. It is a huge challenge for the regulators to keep pace with the markets. The second major issue by far, which I don't think will happen in a while, is letting public sector banks go private. Public sector banks should be widely held public and not government controlled. Indian private sector banks should have the opportunity to buy them or merge them and that is key, because even today 75% of India's savings are with public sector banks. It is a huge pot which requires tremendous growth on efficiency, new products and market place. Additionally, there is going to be a significant need for capital. Either the government has to use the tax payer's money or it will have to dilute or constrain growth.

(Source: ISB Insight, March 2007)