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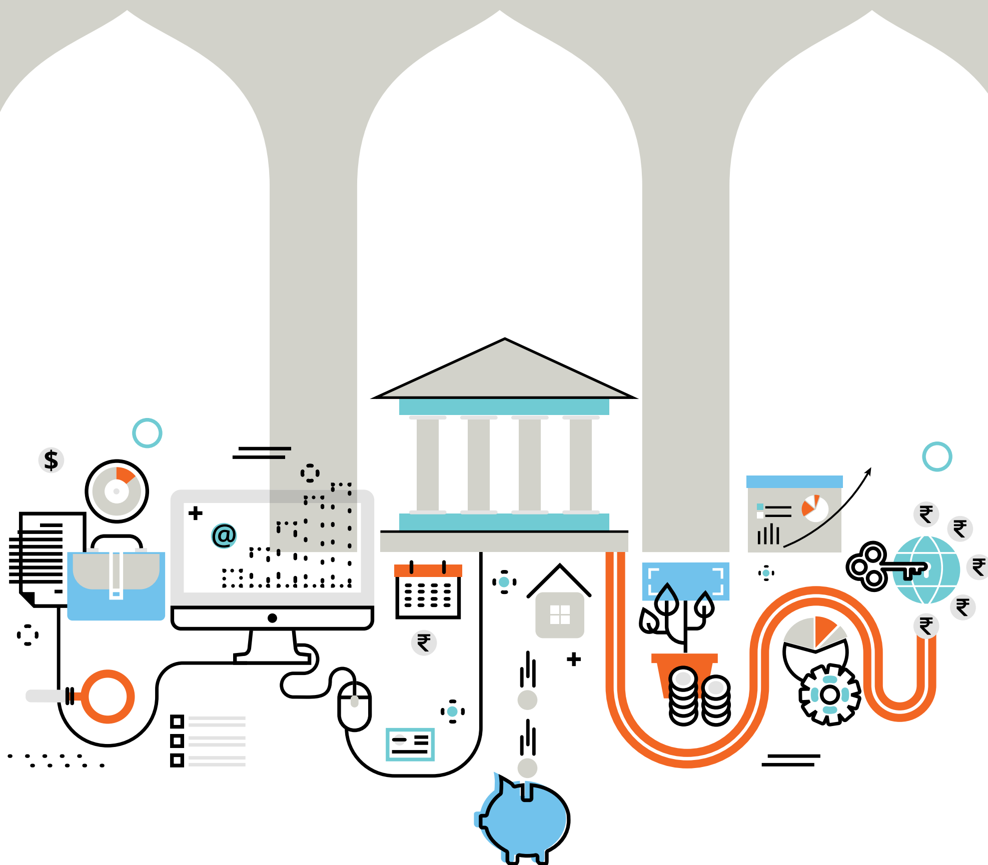
# RESTRUCTURING CORPORATE BANKING IN INDIA

How shifting regulations, markets and technologies are transforming the industry



Written by: The Economist INTELLIGENCE UNIT

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# FOREWORD

Corporate banking in India faces a number of existential issues today, with a majority of banks reporting dismal financial performance in the past couple of years. In fact, any bank CEO or consultant will tell you that banks want to increase the share of retail loans in their total advances. Coupled with the fact that deposits businesses already focus on the retail segment at most banks, does this mean that retail will be the mantra on both sides of the balance sheet?

While corporate banking has traditionally contributed 40-60% of the profits at most banks (and up to 80% for some foreign banks operating in India), the question is whether this is sustainable. What should corporate banks do? Do they need to reinvent themselves? Before we discuss how they should redesign, it is important to answer a key question: Why are we here today?

To my mind, there are four key reasons:

**1. Risk Management**

Many corporate banks have failed to appreciate the fat-tail risks associated with this business and have poorly managed credit risks. They have taken unsustainable risk onto their balance sheets and derived too much comfort from being in the herd. They have failed to recognise that in their highly leveraged institutions, upside is limited to a small spread and downside is unlimited. The odds are heavily stacked against their businesses.

That banks have been reporting non-performing assets (NPAs) of 5-10% tells you how reckless they have been on credit risks. Instead of lending to well-structured projects with sponsors taking on equity risks, banks have unknowingly taken on these risks themselves, without any sector expertise or project-finance assessment skills. Concentration risks have also been inadequately managed. Loose covenants have definitely been an issue as well, and have resulted in higher losses on default. The fact is that in India, until the recent rollout of Insolvency & Bankruptcy Code (IB) laws, the balance of power was

with borrowers, and any resolution or recovery against non-performing loans was unreasonably delayed.

Also, most banks have failed to recognise their reality after the initial problems in the loan books cropped up. In an ideal world, corporate banks would quickly recognise the problem, find a resolution, take a haircut to make the debt sustainable, and move on. Instead, they have tended to evergreen these loans, aided by multiple schemes that helped them kick the can down the road.

**2. Capital Sensitivity:**
Unlike retail banking, where capital allocation is more homogeneous, attention to capital allocation is critical in corporate banking. However, most corporate banks have failed to focus on the capital allocated, as well as the return on it. Many have focused on offering clients balance sheet capabilities as a primary or sole proposition. This comes with high capital costs, while the relatively low spreads in this business result in a poor return on equity (ROE). And since capital requirements are linked to loan ratings as well as the product, one would expect banks to be highly conscious of their risk-weighted assets and the commensurate capital deployed.

However, markets today show that banks do not understand capital intensity or price their loans accordingly. It is quite common to see banks quote 'competitive fees' on non-fund based businesses like guarantees or letters of credit. Many of them pride themselves on higher fee income, but these fees are often capital intensive, and current market prices are illustrative of the lack of understanding of this intensity. This low sensitivity to capital allocation has resulted in poor ROE and shareholder returns.

**3. Pricing:**
The natural follow-through of the two points above is a note on pricing practices. High levels of mispricing prevail in the current market. While unsustainable risks can never be perfectly priced, corporate bankers must learn to price loans while keeping credit risks as well as the capital allocated in mind. It is important for corporate banks to follow a risk-adjusted return on capital (RAROC) model. Had they done so, their balance sheets and loan books might well be in far better shape today.

India's banking market today has lower competition and fewer active players because of the constraints faced by many corporate banks. Normally, this would result in active

banks having pricing power, but that hardly seems to be the case. Credit spreads have continuously been shrinking, and low-rated borrowers are now priced quite close to higher-rated ones. Loan pricing must become more rational; otherwise, ROE at corporate banks will continue to plummet.

**4. Technology:**

Retail banking has so far been the focus of technology upgrades in most banks, and corporate banks have lagged on this front. This is unsustainable. Client executives who deal with corporate banks will demand the same level of service and technology that they receive as retail customers. Also important is how corporate banks will adopt new technologies like API banking, Blockchain, Artificial Intelligence and advanced analytics to better serve their customers, improve efficiencies or manage risk. These technologies, and others, have varied applications in the corporate banking world, but not many banks have invested in them so far.

To summarize, all four of these areas need significant introspection. Risk, capital and pricing must be central to decisions, and this requires a significant change in mindset. Banks must focus on improving non-risk-based revenue to improve ROE and RAROC. Equally important, they need to get far more institutionalised and business-process driven. They will need to move up the curve on digital and technology capabilities, and must reinvent their payment products to meet changing paradigms. The development of bond markets will require banks to acquire capabilities to move from an 'originate for storage' model to an 'originate to sell' model.

While corporate banks have under-delivered in recent years, the opportunity for the few that can get their act together is phenomenal. India's retail lending market is concentrated in the hands of a few banks and non-banking financial companies (NBFCs), and the growth opportunities there are only organic. The corporate credit segment (including small and medium-sized enterprises) is extremely distributed. Consolidation in the hands of a few players implies a tremendous market-share opportunity for successful banks.

This is the rationale for corporate banks to make this transition. Some will succeed but there will, of course, be casualties. This will lead to a degree of industry consolidation, consequently making competition more rational. On the other hand, it will also mean that only top performers will create disproportionate value.

The issues described above have prompted us to get a few experts together to tell us what the future of corporate banks will look like. These experts—consultants, regulators and academicians—have been curated by the Economist Intelligence Unit (EIU) and represent some of the best knowledge in the field. The following articles tell us exactly what India's corporate banks must do to make the best of opportunities that lie ahead.

I would like to thank each of our contributors, as well as the EIU, for their time and efforts in authoring and producing this report. I hope that you, the reader, will enjoy their essays and benefit from the perspective that they offer.

**KVS Manian**
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*By Thomas Olsen and Saurabh Trehan, partners at Bain & Company in Singapore and Mumbai respectively, and Rakesh Pozhath, manager in financial services and information technology at Bain & Company, Bengaluru*

India's corporate banking sector is still in its infancy in terms of product and service offerings compared with developed economies. However, the increasing globalisation of Indian companies along with robust corporate and GDP growth is forcing rapid sophistication.

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Corporate banks in India are finally catching up to their retail counterparts in terms of capturing data, analysing it and leveraging the insights to create digital solutions. Strategic use of data can be beneficial to improving corporate banks' competitiveness, use of capital and overall operations.

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*By Devie Mohan, co-founder and CEO of Burnmark, London*

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*An interview with Nilesh Shrivastava, head of investments, International Finance Corporation, New Delhi*

India's corporate banking sector has been transforming for many years, but recent dynamics have accelerated the pace of change. What is the unique environment in which Indian corporate banks are operating and what does this mean for the market?

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# REMODELING INDIA'S CORPORATE BANKING SECTOR: A MACROECONOMIC OVERVIEW

**The following is taken from an interview conducted by The EIU with Partha Ray, professor at the Indian Institute of Management (IIMCal), Calcutta and former director in the Department of Economic and Policy Research at the Reserve Bank of India, Mumbai. Mr Ray has also served as adviser to the executive director of the International Monetary Fund, Washington, DC. The interview took place on February 15, 2018.**

Before having a discussion of India's corporate banking sector, it is important to consider the salient features of the economy. India's corporate banking sector has been going through a significant restructuring over the past five years. On one hand, state banks are working to improve their balance sheets after accumulating a large amount of non-performing loans (NPLs). On the other hand, Basel-III requirements have raised the minimum capital requirements for banks. As a result, it has become more costly for corporate banks to lend at the same time that the country's growth requires capital to fuel it.

This structural tightening in the market has forced many corporate banks to examine their business models and look to other countries for lessons learned. For example, compared to say the US, India does not have a fully open capital account. The capital account is partly closed in that there are restrictions on foreign ownership of bonds.

One result of this is that debt securities that are issued by Indian corporates and banks are overwhelmingly held by domestic institutional investors, and another consequence is that domestic corporate bond markets are underdeveloped by a number of measures.

India's high non-performing loans (NPLs) have also been a large and growing problem. In the wake of the global financial crisis (GFC) of 2009, the NPLs amounted to just 2.3%

1 https://www.ceicdata.com/en/indicator/india/non-performing-loans-ratio

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of the banks' gross loans[1]. Currently, the NPL ratio is a little over 10%; it is expected to rise to over 11% by September this year.

The reasons for the problem are many. In the wake of the GFC, the RBI took a tolerant view of growing NPLs as a part of its policy response. This was at a time that a downturn in commodity prices damaged profitability in a number of important sectors such as steel. Meanwhile, leveraged companies that were involved in public-private partnerships promoted by the government were hurt by the general sluggishness of the economy. NPLs in these areas grew sharply. There have also been corporate governance issues at some of the public-sector banks.

The authorities are taking steps to deal with the NPL problem. The RBI has introduced new and stricter rules governing the classification of loans. In the short-term, these rules will boost NPLs. However, the true size of the NPL problem will become much clearer. The Indian government announced the injection of Rs880bn (US$14bn) in new capital into 20 public-sector banks before the end of March 2018. More recently, in July, it said it will inject Rs135bn (US$2 billion) more into six public-sector banks so that they can meet capital requirements and extend loan growth.

At the same time, the government and its agencies, such as the National Payments Corporation of India, are encouraging digitisation of financial services in general and payments in particular. This was one of the key objectives of demonetisation—the removal from circulation of large denomination banknotes worth around 86% of the currency in circulation—in early November 2016.

In part because of the sizes of India's population and economy, these are enormous programmes in a global context. They also involve a wide range of Indian actors—the government of India, its agencies, fintechs and the banks themselves. To the extent that foreigners are involved, it is through their ownership of some of the banking system and through the arrival of global technology players such as Google and WhatsApp.

As a result of this and the unique history and nature of India's economy and financial system mean, it will be very difficult for the banks to adopt "turnkey" business models that have been developed in other markets such as North America or Europe. What is certain to happen though, is that the corporate sector will evolve and rapidly to better serve its customers.


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# CHANGING BUSINESS MODELS IN INDIA'S CORPORATE BANKING SECTOR: RISING SOPHISTICATION AND GLOBALISATION

**India's corporate banking sector is still in its infancy in terms of product and service offerings compared with developed economies. However, the increasing globalisation of Indian companies, along with robust corporate and GDP growth, is forcing rapid sophistication. As India's corporate banks develop, their business models will evolve in ways similar to their international peers while maintaining their unique characteristics that reflect the Indian market.**

*By Thomas Olsen, Saurabh Trehan and Rakesh Pozhath at Bain & Company. Mr Olsen is a partner based in Singapore, while Mr Trehan is a partner based in Mumbai and Mr Pozhath is a manager specialised in financial services and information technology based in Bengaluru.*

## The opportunity for change

India's corporate banking sector is a growth market. Industry revenue in India currently stands at approximately US$32bn and is projected to grow by around 8% over the next five years, to over US$46bn.[2]

However, this potential growth is being challenged, particularly by India's high share of non-performing assets (NPAs), which comprise about 10% of gross lending. This stands in comparison to other major emerging economies like China, with NPAs of approximately 2%, or Brazil, with around 4%.[3]

2 Business Standard, "Statsguru: Future of Banking in India", November 13th 2017, http://www.business-standard.com/article/finance/statsguru-future-of-banking-in-india-117111300023_1.html
3 The World Bank, 2017, https://data.worldbank.org/indicator/FB.AST.NPER.ZS

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This NPA crisis can be attributed to several factors, including poor lending practices. As noted by the IMF[4], some banks have experienced deterioration in asset quality and low profitability, while their capital positions may remain insufficient to support higher credit growth. The debt servicing ability of the Indian corporate banking sector has also been affected by the increased cost of financing, inadequate provisioning and compressed margins.

As a result, corporate banks have a limited ability to lend, further exacerbating existing funding gaps in many parts of the market, particularly in the small and medium-sized enterprise (SME) sector. In India, SMEs contributed just 29% of GDP in 2016, compared with over half of the GDP in the EU, in part because of a significant funding gap that is estimated to be about 10% of GDP[5] and around 60% of SME funding demand. This is significantly higher than developed markets like the US (approximately 3%) and France (approximately 6-8%)[6].

In the meantime, large corporates in India continue to be heavily reliant upon corporate banks for funding, as the corporate bond market remains underdeveloped. Traditionally, most bond issuances have been small, private placements held to maturity by passive investors, thus limiting the growth of a secondary market. There has also been extensive crowding out by public entities; government paper dominates the market.

Although restrictions on institutional investors, particularly on foreign participation within the market, have lessened, there are other obstacles ranging from the lack of a robust benchmark interest rate to the inadequate availability of derivative products that investors can use to hedge.

As a result, outstanding corporate bonds in India are worth only around 18% of India's GDP and 60% of wholesale banking credit outstanding. In comparison, the US's outstanding corporate bonds are valued at half its GDP and more than twofold of wholesale banking credit outstanding (including commercial/industrial and commercial real-estate loans).[7]

In the absence of a robust debt market, India's corporate banks lack sufficient capital to develop key services such as transaction banking. Transaction banking comprises only

4 IMF, "India: Financial Sector Assessment Program", January 2018, https://www.imf.org/en/Publications/CR/Issues/2018/01/19/India-Financial-Sector-Assessment-Program-Detailed-Assessment-of-Observance-of-the-Basel-45542

5 SME Finance Forum, www.smefinanceforum.org

6 Vox EU, "Estimating the financing gap of small and medium-sized enterprises", August 21st 2015, https://voxeu.org/article/estimating-financing-gap-small-and-medium-sized-enterprises

7 Bain analysis on SEBI and SIFMA data



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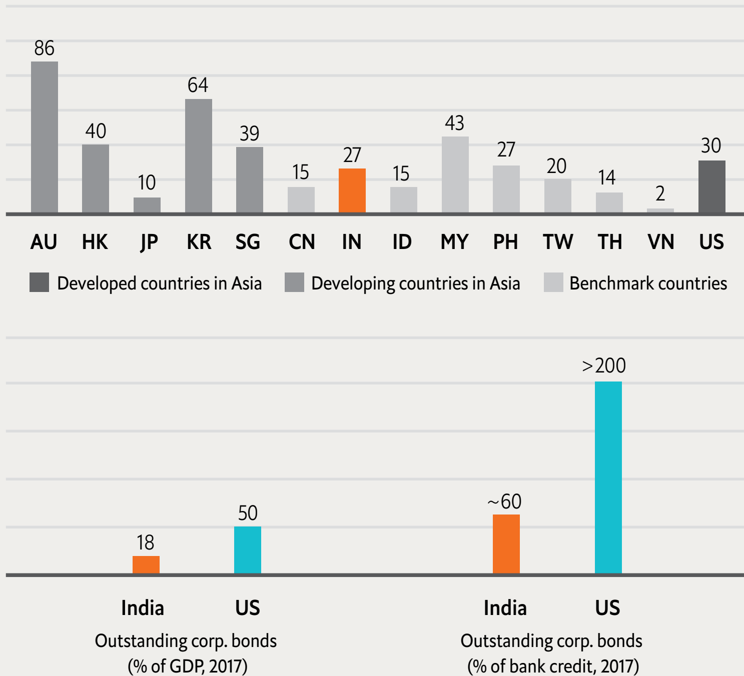
**Figure 1: Sizing India's bond market**

Historically underdeveloped corporate bond market, with significant headroom to grow (%)




Source: Bain & Company

approximately 30% of the Indian corporate banking revenue pool, as opposed to the global average of over 35%.

Regulation has also slowed the development of services such as supply-chain financing. Due to India's high fraud rates and the difficulties associated with obtaining offshore resources, trade finance still largely consists of traditional trade instruments such as letters of credit and guarantees. Globally, trade finance is trending towards open account transactions.

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## Confronting the NPA crisis

There have been concerted efforts to tackle the NPA crisis in India. The amendment to the Banking Regulation Act, allowing regulatory oversight of large defaulters, and the introduction of the Insolvency and Bankruptcy Code are major welcome changes. Regulations that prevent small public sector undertaking (PSU) banks that lack the necessary expertise from participating in consortium lending and a January 2018 directive that instructs consortiums to have at least a 10% share in the financing are also introducing more discipline into the lending market.

The establishment of the Public Credit Registry, which contains all major credit transactions, will help banks to recognise potential NPAs in the future. These changes will affect the way banks identify and resolve stressed assets, and potentially reduce the risk associated with corporate lending to allow banks to expand their portfolios.

## Creating liquidity

The creation of a liquid and effective debt capital market is key to the evolution of India's corporate banking sector. The pool of investment-grade issuers needs to be expanded and entry barriers reduced for lower-rated corporates. Corporates need to be incentivised to turn to the bond market to meet their funding needs, while a robust corporate conflict resolution mechanism will go a long way in building investor confidence. These actions would free up banking capital to be invested in SMEs and other channels with higher risk and return.

Regulatory pushes, like partial credit enhancement (PCE), allowing repurchase agreements and the Reserve Bank of India (RBI, the central bank) placing limits on loan exposures, are advancing this process. For example, directives issued in June 2017 on higher provisioning and capital norms for loans above the normally permitted lending limit and PCE allow smaller corporates with lower bond ratings greater access to more investors. India's Security and Exchange Board (SEBI) is also considering making it mandatory for large companies to raise about 25% of their financing needs in the bond market. The scope may later extend even to smaller companies.



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Government actions should focus on increasing demand for riskier bonds. By allowing insurance and pension funds to invest in corporate bonds that are A rated, below the currently allowed AA bonds, it will increase diversification of investment for these companies.

According to a rating agency, ICRA, AAA and AA rated bonds account for more than 80% of bond issuances. The top ten issuers account for nearly 40% of issuance. Relaxing these regulations will help to ensure a deepening of the bond market and allow mid-cap firms to begin tapping into debt capital markets for their financing needs.

## The future for corporate banks

The dissipation of the NPA crisis will lead to dramatic consolidation within the corporate banking market. The government is already revisiting the recommendations of the Narasimham Committee, which outlines the formation of a three-tiered banking system comprised of three large international banks, eight to ten medium-sized national banks and numerous smaller banks. Only five to seven public banks, those with the strongest balance sheets and deepest market knowledge, are likely to emerge as leaders in corporate lending and project finance.

Smaller banks can then focus on SMEs. Similar consolidation is expected to take place in the private banking sector, thereby transforming the currently fragmented banking landscape.

Besides consolidation, specialisation of corporate banks is likely. This is reflected by the emergence of small finance banks and the recent RBI proposal released on April 2017, for wholesale long-term finance banks, with the latter being focused on long-term, high-value funding primarily for infrastructure projects.

Simultaneously, there will be opportunities for the big, incumbent banks to leverage their client relationships to progress from balance-sheet providers to full service providers, offering the full gamut of corporate lending, transaction banking, and capital markets products and services.

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Growth is expected in the debt capital markets as well, aided by the opening up of both supply and demand channels. High- and medium-rated corporates will borrow more from the market, driving growth in total corporate bonds outstanding to more than 20% over the next five years. This is expected to outpace the growth of the wholesale banking credit market (10% compound annual growth rate), and equal or exceed it in the next five to seven years.

Finally, rapid digitalisation across value chains will transform transaction banking. A number of mature off-the-shelf technology solutions for trade finance, supply-chain finance and cash management can drive automation and create a more seamless customer experience. Advanced analytics will change corporate lenders' interpretation of credit risk and lead to efficient, algorithmic loan pricing. Distributed ledger technology (blockchain) can revolutionise transaction banking, especially cross-border payments and international trade.

Fintechs will help drive this as they improve domestic and cross-border payments and liquidity management services. Although the number of fintechs in India is currently small relative to the scale seen in countries like China, the US and the UK, they are rapidly growing in importance. It is estimated that India has more than 1,200 fintech players, with about two-thirds of them emerging in the past three years. They are small, with a median workforce of just 14.[8] Most fintechs are focused on payments, e-wallets and gateways, leaving the non-payments space, which is most relevant to corporate banking, with quite a bit of headroom.

Taken together, these combined opportunities for growth in India's corporate banking industry— deepened markets, improved regulations and technological advances—signal a future of rapid evolution and maturity. These changes will strengthen the sector's ability to service its corporate clients while extending its lending opportunities, and over time bring it closer in structure and nature to international markets.

8 The Economic Times, "Managing burn rate a worry for fintech startups", March 12th 2018, https://economictimes.indiatimes.com/small-biz/startups/newsbuzz/managing-burn-rate-a-worry-for-fintech-startups/articleshow/63264615.cms


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# **THE DATA TSUNAMI:** RIDING THE WAVE IN INDIA'S CORPORATE BANKING SECTOR

**Corporate banks in India are finally catching up to their retail counterparts in terms of capturing data, analysing it and leveraging the insights to create digital solutions. Strategic use of data can be beneficial to improving corporate banks' competitiveness, use of capital and overall operations.**

*By Joydeep Sengupta and Renny Thomas at McKinsey & Company. Mr Sengupta is a senior partner based in Singapore, with a specialisation in architecting and executing multiyear business transformations. Mr Thomas is a senior partner based in Mumbai, with a deep expertise in strategy development.*

## The rising case for more data analytics

India is amid a data revolution across all spectrums from structured to unstructured data. For example, in 2009 the government of India announced the issuance of Aadhaar cards, which enable a person's name, age, photograph and residential address to all be linked to a unique identity number. This has led to 1.2bn or so holders, who can now transact and bank in India's digital economy.

This and other initiatives have set the precedent for a number of Indian organisations to seek equally robust data from customers and other data sources, and use these to improve and grow their product offerings. Retail banks are already transforming in this direction. Access to different types of data, from consumer behaviour to purchases, has helped banks to deepen their understanding of customer needs and increase their ability to address them in a timely and rightly tailored manner.

However, the impact on India's corporate banking customers has not yet been fully felt, as digital efforts have been less concentrated in the corporate banking space.

This is driven, in part, by Indian corporate banks' struggle to emerge from years of being burdened by non-performing assets and operational inefficiencies. Corporate banks are

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now seeking new ways to be competitive, efficient and profitable in the market. Data analytics can help drive these improvements.

In addition, corporate clients are starting to expect the same digital capabilities that they enjoy as retail banking customers to be available on the corporate banking side.

## Putting analytics to work

Using data analytics to better underwrite credit is one of the first ways India's corporate banks can and are digitising. Traditionally, credit in India has been issued to highly rated multinational corporations through processes that are very manual and, therefore, often subjective. By codifying knowledge, banks can make the evaluation process easier and more systematic, and change their underwriting approaches. For example, credit assessments can include a wider range of factors such as the nature of a business in the context of its industry, the value of a company's inventory and evaluation of the quality of an organisation's operations.

Data analytics can also help corporate banks better manage their credit risk. Capturing and evaluating historical loan performance can help lenders identify patterns that lead to default, and use these to proactively see and respond to risks that arise in their current debt portfolios. Having reliable early warning systems can also help banks feel empowered to take on more risk, as they have more tools to manage and protect against adverse events before they happen.

The protection that data analytics provides can extend into other areas as well, including fraud and anti-money laundering. These are especially useful on the payments side, as trust is a large problem within India's corporate supply chains. Having systems that ensure the safety of transactions can help banks grow their ability to facilitate more transactions and trade.

Finally, data analytics applications can help capture and leverage internal data within corporate banks to better train and develop employees. This can help eliminate bias in credit assessments, create more robust employee assessment tools, and identify manual operational patterns that can be automated. However, much of this comes from unstructured data that often exist in the heads and personal accounts of employees. As a result, it is a challenge to collect and analyse.


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## Improving financial performance with data

For banks that integrate data analytics into their operations, there are significant productivity and profit gains to be had.

First of all, data analytics can help banks optimise their capital positions by enabling them to more efficiently lend. This can empower a salesperson to have more insightful assessments of clients, better evaluate the value and use of collateral, and more accurately price debt. Together, these improvements in efficiency can drive up to a 10% saving in the cost of lending.

This creates pure capital savings that can either go to the profit and loss statements (P&L) or be used to expand banks' portfolios into other types of lending. For example, there is a significant funding gap in India's micro, small and medium-sized enterprise (MSME) market that corporate banks have struggled to fill. Having more robust lending assessment tools can both free up funds and enable banks to more confidently lend to new sectors. Banks could see another 10% improvement in their returns on capital from this.

Finally, data analytics for corporates can also create opportunities already seen in retail banking through greater cross-selling (and conversely less time spent seeking new customers), and more visibility on metrics and strategies that drive more sales productivity. With the right combination of labours put in place, capital savings could further rise to 30%.

## Creating digital ecosystems

Data provide banks with opportunities to build broader digital ecosystems. For example, in providing services to a wide range of conglomerates that operate across both business-to-consumer and business-to-business spaces, banks can use data analytics to act as intermediaries and fill supply-chain gaps. Already in the petroleum sector, Indian banks are plugging into the supply chain, from oil fields to the consumers, as both financing intermediaries and resource exchanges. This is an area where productivity gains can be both huge and uncertain, as creating a digital exchange doesn't necessarily guarantee ownership of it. New players can come in and win away this digital business.

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**Figure 3: Putting data to work**

Advanced analytics can be applied at each step of the corporate banking value chain

| | Advanced analytics value tree | Advanced analytics themes | Client segments: Small and medium size enterprises | Client segments: Middle corporates | Client segments: Large corporates and multinationals |
|---|---|---|---|---|---|
| Revenue increases | Client acquisition and retention | New customer identification | High impact | Low/medium impact | Low/medium impact |
| | | Churn reduction analytics | High impact | High impact | High impact |
| | | Client experience analytics | Low/medium impact | Low/medium impact | Low/medium impact |
| | Client profitability | Next product to buy | High impact | High impact | High impact |
| | | Pricing analytics | High impact | High impact | Low/medium impact |
| | | Trade/solution structuring support | Low/medium impact | Low/medium impact | Low/medium impact |
| Cost reduction | Operational costs | Productivity optimization | High impact | High impact | Low/medium impact |
| | | Predictive error analysis | Low/medium impact | Low/medium impact | Low/medium impact |
| | | Smart ops/trade automation/robotics | High impact | High impact | High impact |
| Risk reduction | Risk losses | Digital credit assessment | High impact | High impact | High impact |
| | | Advanced early-warning systems | High impact | High impact | Low/medium impact |
| | | Trader surveillance | Low/medium impact | Low/medium impact | Low/medium impact |
| | | Next-generation stress testing | Low/medium impact | Low/medium impact | Low/medium impact |
| | Compliance/fraud losses | Anti-money-laundering control | High impact | High impact | High impact |
| | | Fraud detection analytics | High impact | Low/medium impact | Low/medium impact |
| | | Regulatory checks on contracts | Low/medium impact | Low/medium impact | High impact |
| Enablers | (Client) resource consumption | | High impact | High impact | High impact |

Legend: High impact; Low/medium impact

Source: McKinsey analysis

Through growing collaborations with fintech players and technology innovations, banks can also increase their access to new sources of data—both structured and unstructured—that can provide new insights.

Bringing in emerging technologies like artificial intelligence, blockchain and robotics further creates future opportunities. For example, at some point in time the entire credit department of a bank may be run by robots. Blockchain will also be a game changer, but it is still quite expensive and the conditions for its success in India will take longer to emerge than those needed for other technologies.



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## The cost of falling behind

As India's corporate banking grows more digitally sophisticated, new government policies are also promoting more competition by allowing new domestic players to set up payments banks (which can only accept deposits and not issue loans or credit cards) and small finance banks (which provide basic banking services to underserved sections of the economy). It is also easier for foreign banks to enter India's banking sector.

There is also rising competition to address the funding gaps in India, which are significant in both the MSME sector and in infrastructure development. Pressures to fill these needs are driving changes in government regulations, new banking business models, and dynamic shifts in how companies in India—both large and small—seek their capital raises.

As a result, the cost of missing out on the data analytics revolution can be high for those players who don't keep up and, as a result, not every corporate bank will benefit equally. Data are not universally and publicly available to everyone. In the end, the banks that will come out top are those that have access and possess the knowledge to effectively use it.

Therefore, banks should centre their efforts around building supporting elements that allow access to the right data on which they can run new models. This will be the differentiator in the years ahead.

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# LOANS, COMMERCIAL PAPER AND BONDS: INDIA'S CORPORATES DIVERSIFY HOW THEY BORROW

**As India's corporates seek to streamline the time and cost it takes to obtain corporate loans, they are increasingly taking advantage of lending opportunities in India's debt capital market.**

*Saurabh Batra, director of treasury advisory at EY, examines why this trend is growing in popularity but likely to be constrained for some time by factors unique to India.*

India's large corporates are increasingly looking to the country's debt market to help alleviate the regulatory time and costs incurred in the bank lending process. More corporate bond issuance diversifies the borrowing sources for companies and creates healthy competition for banks.

However, unique structural factors in the country mean India has some way to go before its debt capital market is mature enough to truly rival and resemble the banking sectors of more developed markets. In the US, financial markets account for over around 70% of loans to companies, with the majority of this being public debt. In comparison, the bond market in India accounts for approximately 30% of the total credit availed by the Indian corporate sector and the majority is through private placement.

## The ease of issuance: why India's corporates like bonds

Much of what has driven corporates to start issuing more bonds comes from the rising burden of regulations. The Basel III requirements, which India has adopted, increased the amount of capital that banks require, effectively making lending more expensive. This has coincided with moves by the Reserve Bank of India (RBI, the central bank) over the past five to six years to tighten regulations in order to reduce the non-performing loans that are currently plaguing the Indian banking system.



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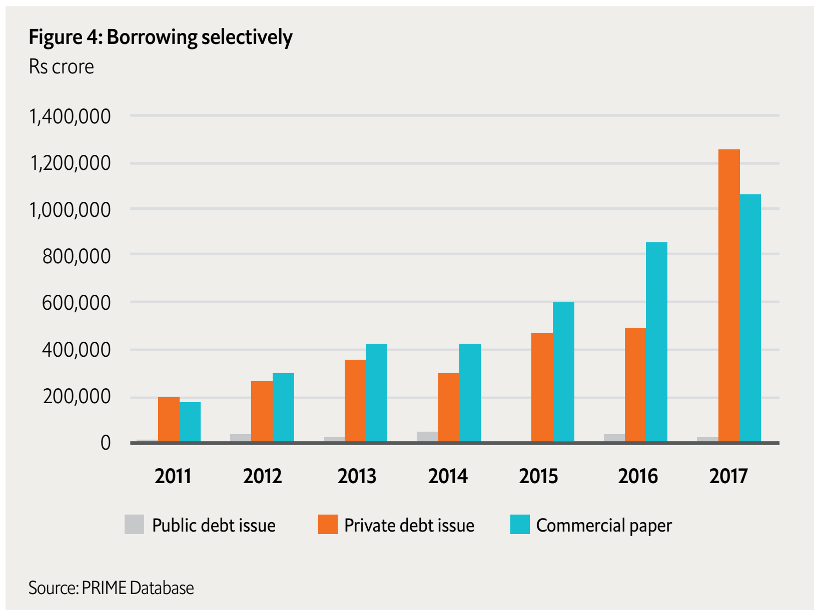


The RBI has also had to address loopholes in India's bankruptcy laws, which has led to further constraints on lending. The loopholes have been problematic, in part because deliberate defaults by large-scale corporate borrowers have been sufficiently large to give rise to systemic risks.

Although this has affected state banks comparatively more than private and foreign ones, the net effect has been to drive the banking sector to take a selective approach in its lending strategy. There is some variation across private and public banks, but India's banks are still primarily focused on doing business with leading multi-national corporations, large Indian corporates and highly rated SMEs.

The due diligence process and regulatory requirements for companies to qualify for loans have also become increasingly arduous, and the cost of borrowing has gotten more expensive due to non-performing asset provisioning and write offs, among other things. Some companies have been able to access the commercial paper (CP) market instead, and obtain short-term funds this way more cheaply than through the banking system.

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However, until recently these entities have been required to have a local credit rating of A1+ (the highest). Not every company wanting to raise financing meets this requirement. Although the bond market still isn't deep enough to support a wide range of credit ratings, it is more flexible than the CP market while still being relatively cheaper and easier to tap than bank loans.

As a result, an increasing number of large corporate borrowers have been managing costs and diversifying their sources of borrowing by issuing bonds. Those most likely to successfully do so have the ability in terms of scale, sophistication, foreign currency cash flows and credit rating—which is usually no higher than the BBB- (S&P) and Baa2 (Moody's) held by the government of India—and have been issuing bonds that are denominated in US dollars or euros in global exchanges for some time. They are natural and easy entrants into India's domestic bond market.

As these large companies help grow investor appetite for bonds, they are also starting to open up opportunities for lesser companies behind them.

## Growing the supply of bond investors

The limitations of India's illiquid debt capital markets are significant. The economy as a whole runs a current-account deficit (equivalent to around 2% of GDP), and excess savings are concentrated in particular areas such as high net worth individuals and mass affluent households. These households have always tended to prefer real estate and gold to financial assets such as stocks, investment products like mutual funds and bonds.

Institutional investors such as pension funds and insurance companies are also less active providers of funding than in other parts of the world. This is partly because of regulations that compel the Indian institutions—including mutual funds—to hold low risk investments such as bonds issued by the government of India or state governments.

This is also because of the dynamics of the pension funds and the Life Insurance Corporation (LIC) of India. Unlike their counterparts in much of the rich world, the pension funds are not suffering from burgeoning liabilities because of demographic trends. Life insurance is underdeveloped by most measures, and the LIC enjoys a dominant


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position in a market that should grow steadily for some years to come. There is therefore less pressure on the Indian institutions than on their peers overseas to seek additional investment returns from lending to corporates.

Another important factor is the absence of credit default swaps in the Indian bond market. Unlike developed markets, the Indian bond market has limited avenues to hedge risk associated with a particular bond. Non-standardised stamp duties across states, limited technology and a lack of functional trading systems play a detrimental role in growth as well.

However, the government is instituting changes to improve market liquidity. First, the government now allows for the issuance in the CP market of structured securities; these qualify for a stable A1+SO local credit rating (debt rating from India Ratings & Research (Ind-Ra)) even if the issuing company does not. This is allowing more mutual funds to invest in CP, driving up demand for the product. Second, the RBI has eased some regulations to permit banks to accept corporate bonds as collateral for loans.

Although these changes aren't enough to drive a rapid maturing of the debt capital market, they are easing liquidity and creating new opportunities for investors.

## Banks are innovating to keep up

For now, corporates still have to rely heavily on banks for their borrowing needs, and are increasingly vocal about wanting more innovative products and greater service from the banks that they deal with. They also want reduced documentation and shorter times for loan approvals.

The banks are responding in a number of ways. All are looking to provide more robust digital business solutions for clients. Embedded in this effort is a focus on improving transaction and analytic services, such as pooling and management of cash balances. Cash pooling improves transparency, facilitates handling of debtors and creditors, and reduces costs.

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Some banks have also expanded their lending strategies. For example, supply-chain financing is becoming more sophisticated and popular, the rationale being that money lent to corporates for working capital will ultimately be passed on to the corporates' suppliers regardless. Moreover, the benefit to the bank is that a single and possibly risky exposure to the corporate is replaced by a number of smaller and more manageable exposures to the suppliers.

## Looking forward

It is difficult to identify a single "game changer" that will make it significantly easier for corporates to access funds from banks, although the massive recapitalisation of the banks that is currently under way will undoubtedly help.

Meanwhile, it is equally difficult to see a single factor that could spur the rapid deepening of India's debt capital markets, although liberalisation of the capital account—including the promotion of financial centres such as GIFT City in Ahmedabad—would definitely help.

What is certain, though, is that new technology will enable the corporates, banks and markets to do business more cheaply. Payments, trade finance, trade documentation and other activities will become faster and less costly thanks to artificial intelligence, blockchain and other technologies. This will drive change in all segments of the lending market in the future.



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# THE NEW PAYMENTS COMPETITION IN INDIA: DIGITAL BOOSTS SPEED AND EFFICIENCY

**Corporates and business leaders have come to expect the same level of payments services in their business lives that they see in their personal lives. To deliver the solutions their customers now demand, corporate banks face a growing need to innovate and partner with financial technology firms (fintechs). Only by striving to enhance their business model further and deliver a far better experience can corporate banks remain competitive.**

*By Devie Mohan, who is a fintech industry adviser and analyst based in London. She is the co-founder and CEO of Burnmark, a fintech research company, and a panel member of the ING Group Think Forward initiative on better financial decision-making. Ms Mohan is actively involved in the fintech community and has been listed in CityAM's top ten fintech power list, and in Innotribe's fintech power women list. She was also the only Indian woman in the top 50 of the GlobalData Financial Services' list of top 100 fintech influencers on Twitter last year.*

## High corporate expectations

Consumer payments have evolved rapidly in India over the past several years and the country is now a global payments innovation leader. Local companies such as Paytm have delivered digital payments solutions to millions of consumers as well as small businesses and multinationals, while multinationals such as Amazon and Google have also chosen India as the place to launch new payments services.

Corporate expectations for payments have risen too, with their demands reflecting what they see in retail payments. CEOs of corporates may be clients of Google's Tez or Paytm, for instance, so they expect the same level of customer experience for their corporate payments.

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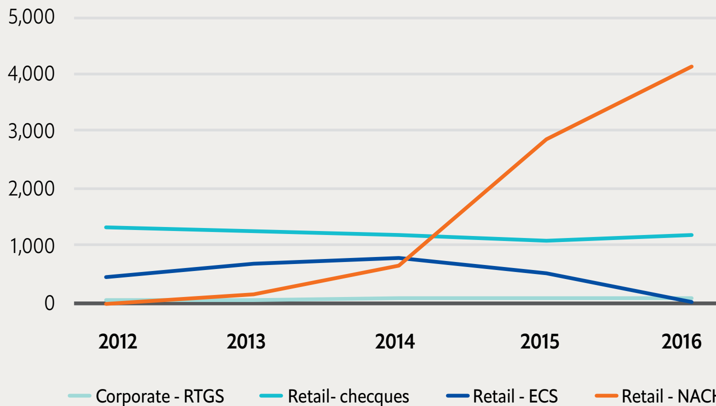
## Corporate digital payments lags consumer payments

Despite these high expectations, development has tended to lag in corporate payments. Indeed, corporate payments are often still trapped in paper bills, cash transactions and files saved for audit trails.

**Figure 5: Late to the game**

Corporates and consumers still use many non-digital methods for payments (Number of transactions)




Real Time Gross Settlement clearing system (RTGS); Electronic Clearing System (ECS); National Automated Clearing House (NACH) Source: Bank for International Settlements

Payments data are still captured in a variety of different forms and systems, resulting in errors and inefficiencies. Capabilities for tracking payments are limited, accuracy is a challenge and the number of people needed to check payments is higher than it should be because automation is lacking. Despite the success of fintechs in offering innovative consumer payments, corporates have also been lagging in offering mobile apps or other services for business-to-business (B2B) payments that would increase efficiency.

These inefficiencies lead to high costs for payments at many corporates, which are still often paper-based. Regulations that require two or three copies of many documents for audit purposes exacerbate the difficulties and result in relatively inflexible processes for operations.



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Along with the challenges at corporates themselves, solutions for corporate payments at banks have lagged as well.

Many banks still have legacy systems, which result in operational inefficiencies for know-your-customer (KYC) compliance, accounts payable, accounts receivable and a variety of other trade practices. Furthermore, corporate banking is as siloed in India as in other parts of the world, resulting in separate departments for payments, cash management, treasury and even relationship management. The result is that corporates have fragmented relationships and products, which banks need to bring together in order to offer real innovation.

Finally, B2B payments can be slow and sending payments via the correspondent banking networks such as SWIFT is expensive. Although new payments networks are being formed outside of correspondent banking, bypassing current networks and reducing fees while also speeding up payments, the cost of payments will probably remain high until new networks such as NACH are fully in place.

## Emerging technologies to keep banks competitive in payments

Given the need for change to meet corporate customers' demands and to increase their competitiveness, leading banks are beginning to take steps to enhance their services.

One of the biggest changes relates to data, led by banks starting to use artificial intelligence (AI) in areas such as contracts, negotiations, tax filing, clearance and documentation. Using AI to predict behaviour and provide data visualisation has, for example, enabled faster decisions and large cost savings. Leading banks are also using their data from lending and payments or other sources so that they can leverage AI to offer the right products. Along with developing teams in-house to build AI solutions, banks have started to partner with universities and with companies outside India.

Some banks have also automated their internal practices for services including e-invoicing, correspondent banking, KYC, credit scores, cash management and invoice management. These solutions are solving some of the challenges, especially as banks can do more

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with fewer people, and reducing costs. A more recent catalyst is the requirement by the Reserve Bank of India (the central bank) for bank and non-bank companies to issue meal vouchers in electronic reloadable formats and to switch from paper to digital this year.

Another catalyst for automation has been changes in regulations for the national goods and services tax that have consolidated a multitude of state-based taxes into a single national tax and led banks to automate processes to deliver supporting services. While some banks have developed entirely new solutions, others are building a digital layer on top of existing systems or partnering with fintechs.

To enhance their connections to corporates and build their capabilities in payments, leading banks have begun to use open application programming interfaces (APIs). APIs, such as ones that link restaurants to Google Maps, can enable companies to set up an interface to their bank and download data directly. Rather than reconciling payments manually, for instance, data that come in through the APIs can be used to automate reconciliation. Open APIs also enable other customisation by corporates, which leads to immense time and cost savings in areas including payments, treasury, trade and cash flow management. The "India Stack", which allows the government, citizens and entrepreneurs to interact more easily, is a key enabler of these APIs.

Blockchain is starting to offer opportunities as well, with some Indian banks already using it for trade transactions and overseas remittances. As blockchain usage grows, sandboxes are forming and enabling further innovations. One example is Primechain Technologies' creation of Bankchain, a group for bank developers that expects to grow from 24 members today to about 750 by 2019.

Moreover, a small number of banks have signed on to SWIFT's global payments innovation (gpi) initiative so that they can provide faster payments for corporate clients. Along with increased speed, gpi enables corporates to track payments across correspondent banks and obtain better data about their payments. Some banks have also begun to use Ripple as a tool for faster cross-border payments.

Even when they are able to put the tools in place, however, one challenge that many


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banks still need to overcome is a lack of a strategic view on how all these initiatives come together. Another issue that looms large for banks is effective implementation, hindered by insufficient focus on areas such as e-invoicing or eliminating paper. Unless there is sufficient strategic focus and a change in the bureaucratic silos, banks may not be able to save much in the short term and will only reap the benefits of change far in the future.

## Collaboration with fintechs

Along with developing solutions themselves, banks are taking advantage of collaboration with fintechs to move faster. There are plenty of opportunities: a survey by an Indian trade association, Nasscom, and a global consultancy, KPMG, indicated that approximately 50% of Indian fintech firms are focused on payments and trade processing.

A fundamental change that is part of this fintech revolution is in the way that data are managed, especially for services such as small and medium-sized enterprise (SME) payments, credit scoring and KYC. Given that 70% of SMEs say cash-flow management is their biggest issue, this focus on using data and payments to manage cash and reduce costs is especially important.

Paytm has launched a service that helps companies pay for goods from Europe directly without a foreign-exchange conversion, for instance, while Mobikwik's Magic helps companies with employee benefits and expense management. Happay offers SMEs a prepaid payments solution to handle their payment requirements, while NiYO and Zeta are digitising reimbursement calculations and payments.

Whereas there was disaggregation in areas such as treasury and invoice management over the past five years, as fintechs made services cheaper and more transparent the trend has reversed, and aggregation is increasing. Fintechs are thus forming partnerships, merging or being acquired by banks. Banks are then using this aggregation to create new products, develop new distribution mechanisms and offer new ways to deliver better solutions to corporate clients.

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## Change drives better performance

While challenges remain for corporate payments in India, leading banks are creating a wave of change and acquiring or partnering with fintechs to automate their processes, increase efficiency and deliver the more effective solutions that their corporate customers demand. Bankers and corporates alike will need to make sure they act quickly to take advantage of the changes and remain competitive in the years ahead.


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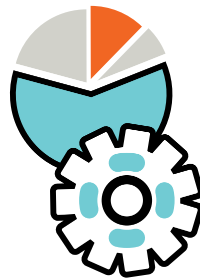
# FROM SIMPLE TO SOPHISTICATED: CHANGES IN THE LENDING STRATEGIES OF INDIA'S CORPORATE BANKS



**India's corporate banking sector has been transforming for many years, but recent dynamics have accelerated the pace of change.**

*The following is taken from an interview with The Economist Intelligence Unit (EIU), Nilesh Shrivastava, portfolio manager at the International Finance Corporation (IFC) in India (the investment arm of the World Bank). In an interview with The Economist Intelligence Unit (EIU), Nilesh Shrivastava, portfolio manager at the International Finance Corporation (IFC) in India (the investment arm of the World Bank), discusses the unique environment in which Indian corporate banks are operating and what it means for the market.*

**EIU: India's corporate banking sector is currently being affected by a variety of forces: a national restructuring of balance sheets, rising financial inclusion and greater digitisation of services. From the point of view of the IFC, how does this impact the lending strategies of corporate banks?**

**Nilesh Shrivastava (NS):** One of the important changes that has taken place over the last decade or so has been a redefinition of the concept of corporate banking in this country.

In the early 2000s corporate banking—especially among the private sector and foreign banks—largely involved the provision of a variety of services to the local subsidiaries of multi-nationals, like Unilever or Vodafone, and very large Indian corporates. A bank would facilitate large lending or syndicated transactions and provide cash management, working capital finance, foreign exchange, trade, and/or offshore services.

From a pricing perspective, the bank's management would look at the profitability of the entire relationship: some of the services would typically be seen as loss-leaders, while others would generate profits.

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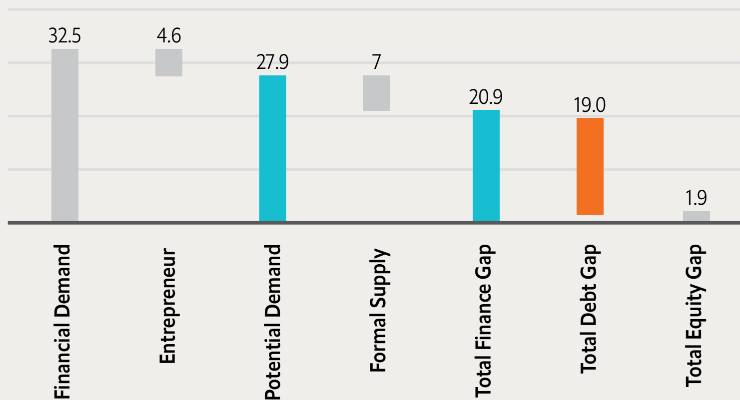
The downscaling of corporate banking began from the mid-2000s. Many foreign and Indian banks opened what they called their small and medium enterprise (SME) units and began catering to mid-sized Indian corporates. At first, these clients were brought on board primarily for large lending services, but their banking relationships soon expanded. The credit gap and the opportunity in the SME space were significant factors that allowed banks flexibility to enter the space based on their comfort and risk profile.

**Figure 6: Minding the gap**

Measuring the demand-supply gap in SME financing (INR Trillion)




Source: MAPE Group

**EIU: How has this expansion in the client base changed the corporate banking industry?**

**NS:** In India, as in the rest of the world, there has been a commoditisation of pricing and services in the traditional corporate and institutional banking segment. In this environment, international or global banks initially had an advantage relative to Indian banks. This is because global banks had slightly greater access to global networks, the benefits of offshore business centres in Singapore and elsewhere, and better links with trade/correspondent banks. Therefore, when Indian corporates expanded regionally or globally, they could play a role.



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However, Indian banks, especially private-sector banks, responded by moving relatively quickly away from the top ten to 20 corporate names and into the larger Indian corporate and SME markets. This has corresponded with rising sophistication among Indian corporates; as they have grown to take more risks, they have also bulked up their balance sheets substantially.

Indian private-sector banks have learned how to work with these SMEs, particularly in the way they assess their creditworthiness. For SMEs, the analysis must be much more cash-flow driven and must include information from cash management/trade and other transaction-related services. It must include an understanding of where a company is in the business cycle and where it is in the entire value chain in the market in which it works. This process has not been linear and there have been phases—where banks became aggressive, bore some losses, retreated and then again became aggressive as credit understanding and systems improved.

Banks are going much deeper into the vendor/dealer supply chains and ecosystems of their large corporate clients as well. Earlier, companies were not so focused on their supply chains but banks are now much more integrated into their clients' ecosystems. Even among IFC's clients, we are seeing newer banks like AU Small Finance Bank moving actively across the SME space, trying to provide them with holistic banking solutions.

This growing level of sophistication is driving new opportunities for the corporate banking sector, but it also adds new costs and need for technology. Greater complexity and personalisation of services means banks need to invest more in technology and relationships management.

**EIU: Given the pricing and other market pressures, how are Indian banks growing their profits?**

Relative to traditional corporate banking, the profitability—in terms of return on equity (ROE) and other metrics for banks—is a lot higher when working with SMEs and mid-sized corporates. This is true even after allowing for the higher risks, which we are seeing the more successful banks in the space deliver. For large corporate clients—while transaction

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specific profitability is very low—those banks that can deliver services across supply chains or geographies are still able to make decent returns.

Profitability is something that top managements in many banks are very focused on these days. Most private-sector banks are publicly listed with investors who seek a certain ROE and employees with share ownership programmes. These programmes play an important role in compensation of the senior staff.

I'd add, however, that opportunity is not spread evenly across all banks. Traditionally, the public-sector banks have had a market share of about 70% in the Indian banking space. Their ability to expand their activities with SMEs and in the mid-market space has been constrained by limits on their capital and non-performing loans, a problem that has been widely publicised.

In the meantime, there is emerging competition from the new and specialist banks. They are starting from a zero base, and are not held back by legacy technology. Through greater digitisation and speed, they are going deeper into several market segments, both creating new markets and gradually taking market share.

**EIU: You are painting a picture where the banks are dynamic and not conservative in terms of lending.**

**NS:** A decade ago, I would have agreed with the proposition that India's banks were overly cautious in their lending. Now, I would say that the private-sector banks are more advanced, and have shifted away from a traditional situation where some 70% of their loan book came from lending to large corporates to one where the figure is going below 50% or less. There are ongoing challenges and phases where corporate banking becomes less or more risky, but the trend is clearly to expand the lending book and services well beyond traditional corporate banking to large corporates.

The remainder of the bank balance sheet does not just include lending to and providing services to SMEs. It also includes the whole gamut of retail services, ranging from credit cards and consumer finance for mass affluent customers to basic payments for first-time users of financial services.



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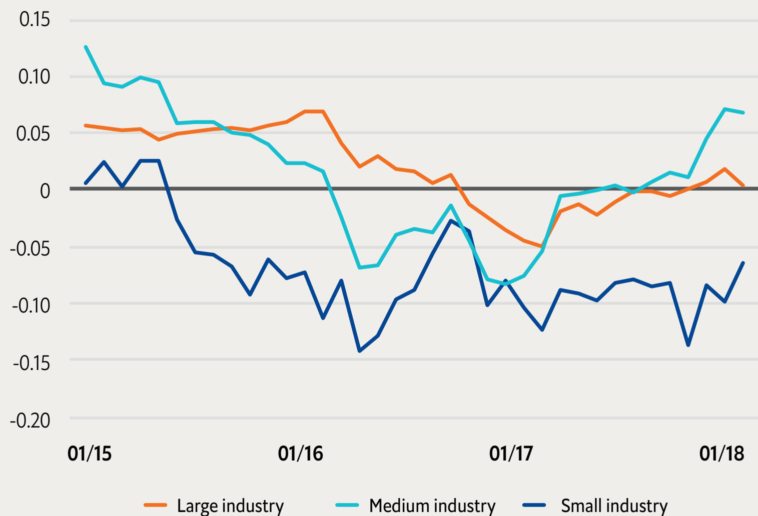
**Figure 7: Shifting tides**

Percentage changes in the balance of lending between corporates and SMEs by month




Source: Haver Analytics, Reserve Bank of India

Initiatives such as Aadhar—the issuance of a unique biometric-based identity to each Indian resident—and the development over recent years of credit bureaus means that it is getting easier for banks to get to know customers who were outside their reach and extend banking services to them. In the meantime, digitisation is reducing the cost of reaching out to customers who are geographically distant from any physical branch of the bank.

The result is, as we know, a massive transformation in retail banking in this country. Strictly speaking, this falls outside a discussion of the interaction between banks and corporate or SME clients. In practice, it is an important issue and impacts banks on two fronts. One, it's getting easier to reach out and assess retail and SME clients and, second, profitability considerations are shifting balance sheets in favour of the retail/SME segment unless a bank has a specific USP(unique selling point) like international reach or product capability.

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I would add that all this change is becoming possible because the Indian private-sector banks collectively are well advanced in terms of their usage of technology—both at the bank level as well as in the ecosystem. Those banks that lag on technology are clearly starting to lag on the business front too.

**EIU: Do you see major limitations for the Indian banks?**

**NS:** One challenge is that the Indian banks do not yet have scale in a global context. According to S&P, there was only one Indian bank among the 100 largest worldwide in terms of assets in 2016: the State Bank of India.

This challenge may be related to another challenge. Indian banks have historically not been particularly adept at international expansion. Some Indian banks have made tactical acquisitions outside India—purchasing wealth management businesses in London, for instance, or focusing on the NRI client base. However, none of the Indian banks have expanded outside the country by way of large-scale acquisitions in the way that Santander, HSBC or Citibank have.

**EIU: What role in corporate financing is being played by the debt capital markets?**

**NS:** The Ministry of Finance envisages that debt capital markets (DCM) should be able to meet at least 25% of all corporate financing needs going forward. It makes sense for domestic pension funds, insurance companies, mutual funds and other financial institutions to be involved with corporate funding through DCMs, expanding investment opportunities for them too.

Experience in other countries shows that DCMs provide much greater opportunities in terms of tenor, rates and terms than bank lending. Arguably the banks are made stronger by competition from DCMs. It forces them to become more innovative. The current developments in the DCM space are positive, but clearly there is a long way to go.

In India, the IFC has encouraged the development of DCMs through issuing Masala bonds. These are rupee-denominated securities that are held by foreign investors. It is encouraging for us that after our first transaction, other market participants have actively adopted it.



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