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Mastering new realities
A blueprint to transform Indian banking

McKinsey India Financial Institutions Practice
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Executive summary

India's banking sector is a study in contrasts. The industry supports one of the fastest growing large economies in the world. Positive macroeconomic and technological trends are driving the growth of new opportunities in the sector. Yet the sector is grappling with a set of "new realities" that are testing its strength and resilience. Challenges like high stressed asset levels and fragmented industry structure are dragging down performance and threatening future growth.

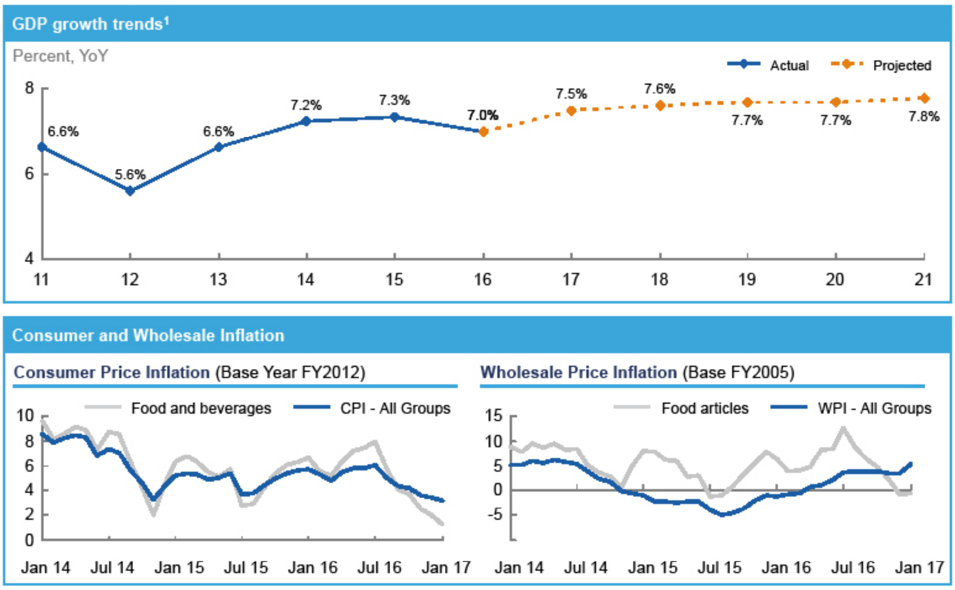
Urgent attention is required to ensure that the sector can continue to be a key driver of Indian economy. Decisions made and actions taken by the various stakeholders over the next five years will determine if the sector is able to "master" the new realities—it could either follow the status quo path to likely contraction or implement a comprehensive change agenda required to take Indian banking to a brave new world. Recent steps announced by the government, like the ordinance to amend the Banking Regulation Act, 1949, have set the stage for taking this agenda forward.

Secular trends make Indian banking inherently attractive

Multiple macroeconomic, demographic, and technological developments make the Indian banking sector one of the most attractive opportunities globally. The broader Indian economic growth story continues unabated—GDP grew at 7 percent in 2016, and growth rate could increase to 7.7 percent by 2020 (Exhibit 1). Additional indicators like upward consumer mobility also point to a bright macroeconomic future.

Exhibit 1

Key macro-economic indicators for India are trending up



1 GDP at constant prices

SOURCE: IMF; Ministry of Statistics and Programme Implementation

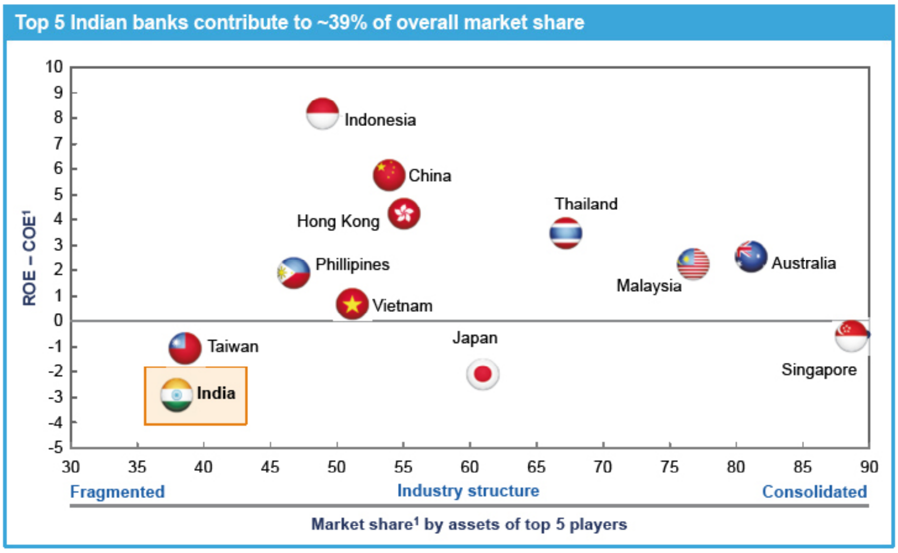
However, even more significant is the pace of digital adoption in the country. India continues to outpace many major economies in growth of mobile usage. Recent government-backed initiatives like Aadhaar, DigiLocker, and IndiaStack are creating something unprecedented—publicly accessible, unified digital infrastructure through which customers can allow financial institutions to access their information. The development of this infrastructure presents extraordinary opportunities for Indian banking.

Perfect Storm in banking in India; immediate interventions needed

Despite these positive trends, Indian banking is under stress. Inherent structural challenges are getting exposed as the industry has been subjected to multiple shocks over the last few years. Indian banking sector lags behind other countries on health, risk, and efficiency metrics. The key challenges are high fragmentation levels (Exhibit 2), limited differentiation among players, and the inherent restrictions of state ownership on the PSBs.

Exhibit 2

Indian banking sector remains highly fragmented, compared to almost all Asian markets



1 Average 2013-2015, 2012-2014 for Australia; 2 1 USD = 65 INR 3 By asset size

SOURCE: Capital IQ; Annual reports; RBI

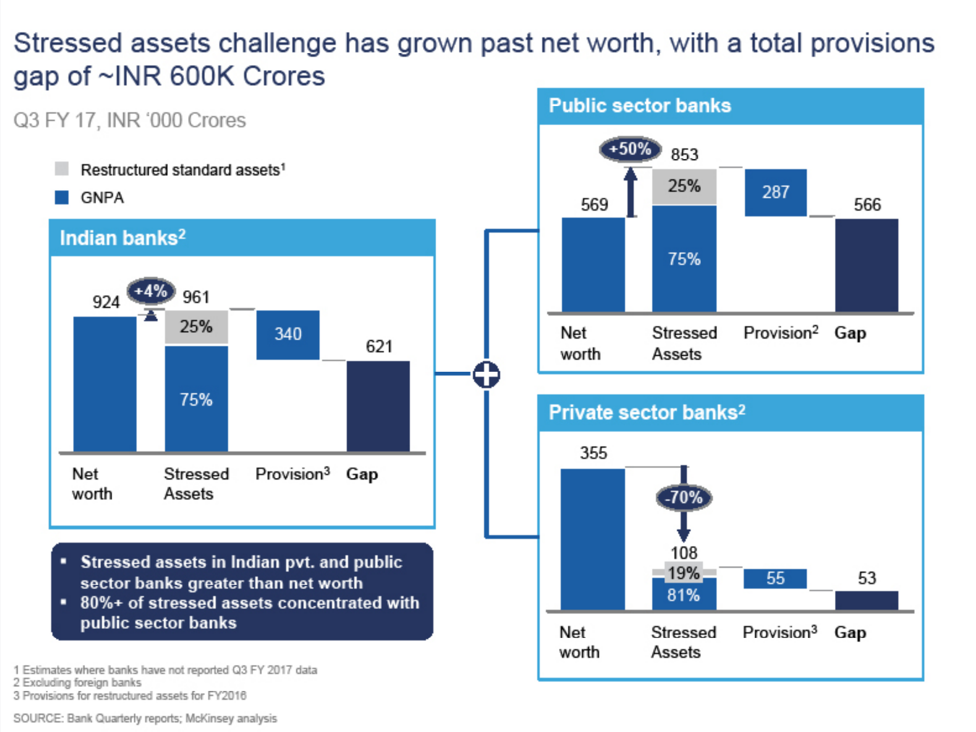
As a result, banking in India is in a "***Perfect Storm***" –

- **At the macroeconomic level**, despite one of the deepest continuous rate cuts since the financial crisis, credit growth has stagnated. Loan volume has shrunk by 0.1 percent[1] between March and December 2016, as Indian corporates deal with a large burden of distressed loans. Moreover, the 2016 demonetisation exercise brought massive levels of surplus liquidity into the system—this deposit surge, along with credit slowdown, has brought down the CD ratio of banks.

- **The stressed asset burden** continues to grow, with the distressed loan volume crossing INR 10 lakh crores in December 2016. The challenge is especially acute for the public-sector banks (PSBs), where stressed assets surpass their net worth. Current provision levels are inadequate, with a gap of nearly INR 600,000 crores between the level of stressed assets in the system and the provisions made. As these stressed assets continue to turn bad, the entire equity base of the banks could be at risk (Exhibit 3).

1 Reserve Bank of India.

Exhibit 3



- **Dramatic technological shifts** are surfacing new opportunities and challenges for banking. Indian consumers are more digital than ever, with a dramatic fall in costs driving a surging growth in internet use. Consumers increasingly turn to digital channels to meet their financial needs, but this means that the traditional value chain is vulnerable to digital disruption.

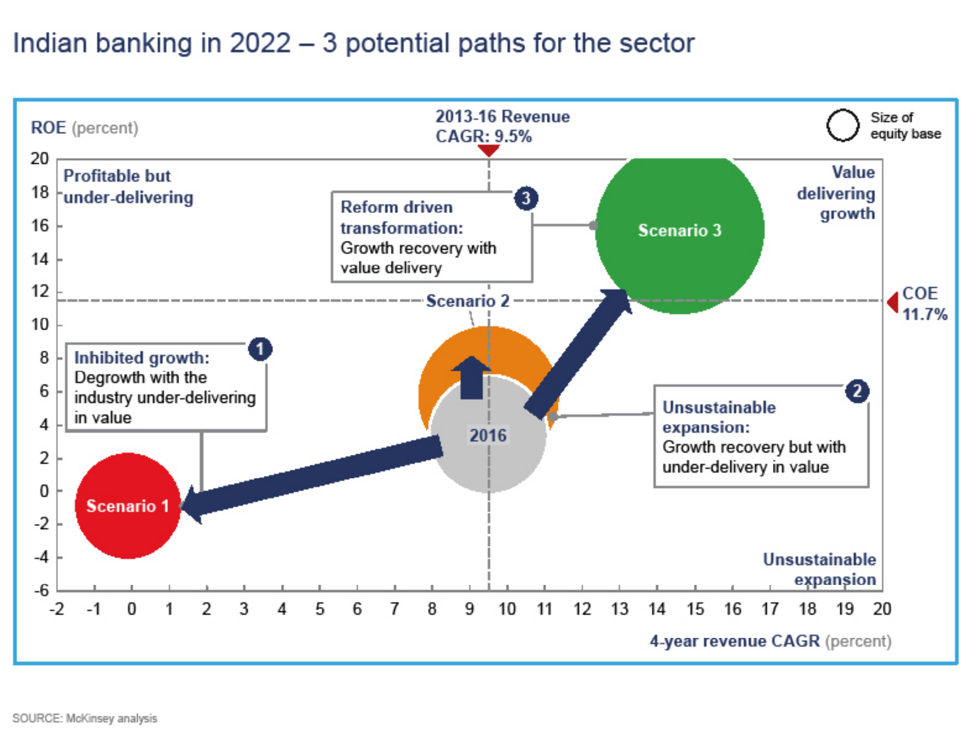
- **The changing regulatory posture** is facilitating the emergence of a digital, inclusive, interoperable, and competitive financial services market. An overhauled banking license regime is encouraging the entry of new players, both domestic and foreign. Government interventions are enabling digital business models through the creation of hard, publicly accessible data assets. However, growing restrictions on corporate lending practices could have a chilling effect on wholesale loan growth.

As the "perfect storm" continues, the industry is becoming increasingly polarized. Private-sector banks outperform the state-owned ones and continue to capture an ever-greater share of the market, as the latter remain burdened by legacy and the constraints of public sector ownership.

If the status quo continues, the sector will be unable to support the Indian economy

With this perfect storm of changes, the Indian banking sector is now at a critical juncture in its evolution. Analyses of various possible scenarios over the next five years indicate that the time for business as usual in Indian banking is at an end. Exhibit 4 captures the three likely scenarios for the future of the sector.

Exhibit 4



SOURCE: McKinsey analysis

- **Scenario 1—Containment and contraction:** If the Indian banking sector continue to maintain the status quo, the crisis situation will continue, with falling growth in corporate loans, high non-performing assets (NPAs), and continued polarization of the sector. As a result, the sector is likely to contract and move further into the realm of unprofitability. Indian banking may then become unable to meet the financing needs of the growing economy.

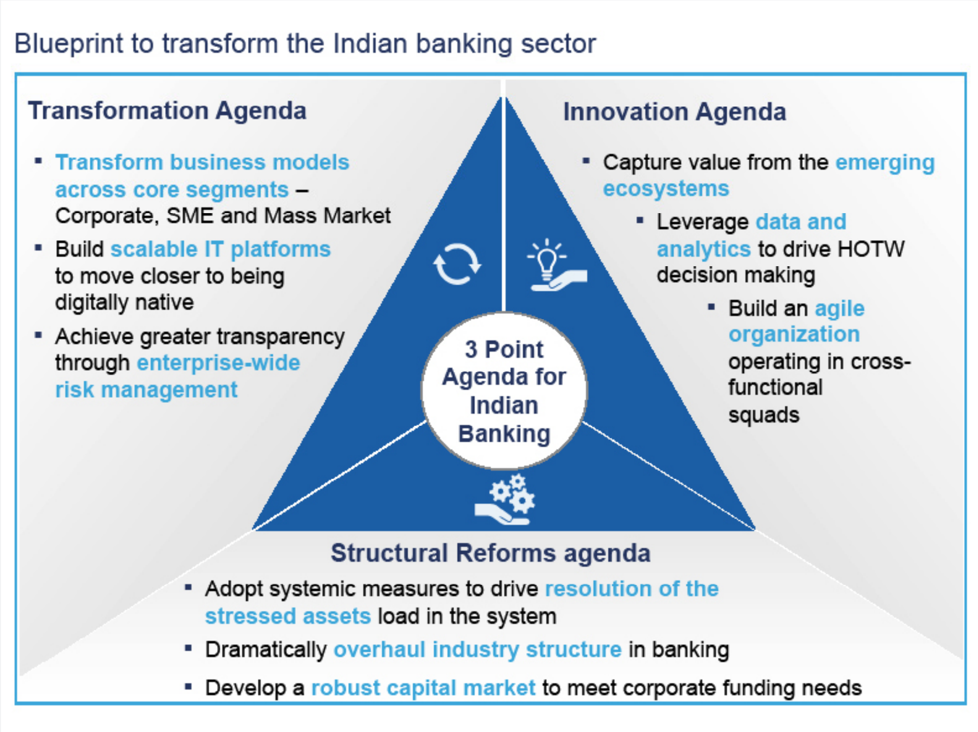
- **Scenario 2—Unsustainable expansion:** A short-term fix is possible through external capital infusion to cover potential stressed assets losses and provisions. This may temporarily revive sector growth, but without making major structural changes, this growth would be unsustainable in the long run.

- **Scenario 3—Structural transformation:** Long-term change and value creation is possible but only with sector-wide reforms and a complete reinvention of traditional business models. This report explores in detail the changes needed to make this possible.

Breaking the shackles—a blueprint to transform the sector

A comprehensive reinvention of the Indian banking industry is possible only with both structural changes in the sector as well as individual bank-level transformation and innovation. The report proposes a three-point blueprint of change covering actions both at the industry and individual bank level (Exhibit 5):

Exhibit 5



- **Structural reforms agenda** for the industry to address the major challenges affecting banks across the country.
  - Develop a **systemic solution to the stressed-asset challenge** by leveraging partnerships with private asset management companies (AMC) and private capital and expertise to maximize value for the banks.
  - **Drive a dramatic structural overhaul of Indian banking** through multiple measures, from consolidating select PSBs, to leveraging public-private partnerships to strengthen capabilities, to exploring the opportunity to bring in private capital in state-owned banks.
  - **Strengthen the Indian capital markets** to meet corporate funding needs through bonds and securitization opportunities.

- **Transformation agenda** for the banks to drive efficiency and profitable growth

  — **Transform existing business models to address the core business segments**—from corporate banking to MSME to mass market, to become more efficient in credit assessment and service delivery.

  — **Drive digitization** to dramatically drive down costs, by building scalable IT platforms that seamlessly integrate the front- and back-end applications with external data ecosystems.

  — **Create a bedrock of robust enterprise risk management** and greater transparency, through a quantitative perspective on risk health assessment.

- **Innovation agenda** to disrupt and expand into new opportunity areas, as well as tap into the emerging channels to reach and service the customers.

  — **Capture value from the emerging ecosystems**, where banks can expand beyond their traditional domains and take over the ecosystems orchestrator role in the coming integrated network economy.

  — **Embed advanced analytics capabilities**, to drive greater business value, efficiency, and enhanced customer service delivery through "hands off the wheel" decision making. This will require banks to build distinctive analytics capabilities in technology, people, and to deploy these assets in high-priority use cases.

  — **Shift to an agile organization structure**, moving away from the traditional silo-ed and vertically segregated structures and operationalizing agile cross-functional squads.

Solving the critical and complex challenges facing the Indian banking sector will require concerted action from all stakeholders. Only a truly transformative execution supported by structural reforms can enable Indian banking master the new realities.

This report is structured as a three-volume series on the transformation blueprint for the Indian banking sector, as follows:

- Volume 1 covers an evaluation of the current state of the sector, the future outlook, and the structural reforms agenda.

- Volume 2 details the transformation agenda for Indian banks, across core businesses and functions.

- Volume 3 outlines the innovation agenda for Indian banks, to build and leverage new capabilities.

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