Searching for new frontiers of growth

Indian banks

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Foreword

The Indian banking sector has performed extremely well over the last few years. The sector has shown resilience by coming out strong during the global financial crisis of 2008. However, this time round, banks face a tougher challenge with the global economy facing the brunt of the Euro zone crisis and the slowing down of our domestic economy under the cloud of high inflation. The non-performing assets are rising with certain sectors such as infrastructure and agriculture under increasing stress. Banks are also facing challenges as customers have become more demanding and their loyalties are diffused with low switching costs. With minimal product differentiation, it is important for banks to provide excellent services with some significant value addition to retain old customers and attract new ones. Banks need to search for new frontiers of growth through innovative business models.

This report highlights the need for banks to engage customers through superior products and services, and use digital innovations like social media, mobile banking and cloud computing platforms to search for new revenues in a cost-effective way. Banks will have to develop next-generation solutions using these technologies to forge ahead in the crowded marketplace as well as improve penetration to achieve the goals of financial inclusion.

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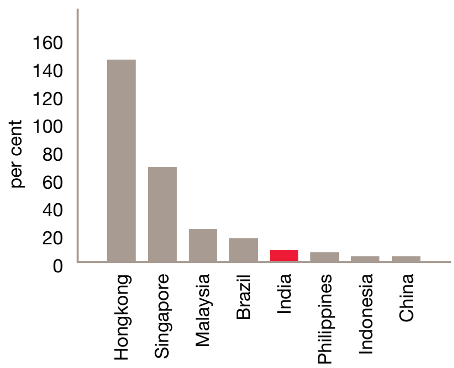
Impact of global financial crisis

Indian banks had emerged unscathed from the global financial crisis in 2008 because they had limited exposure to riskier assets. Moreover, India's strong domestic economy was driving growth at much higher levels compared to its global counterparts. The global financial crisis was a result of the collapse of the sub-prime market, leading to the failure of the shadow banking system (including non-banking entities), which was not regulated as strongly as the commercial banks. Investment banks like Lehman Brothers, Bear Stearns and JP Morgan were leveraged much more than commercial banks and as the crisis hit, they were forced to de-leverage by selling assets in a falling market.

The current slowdown in the global economy has its nerve centre in the euro region. However, all major economies in the world have been affected. The current crisis has its roots in the 2008 crisis, when governments across the world adopted expansionary monetary policies. As government expenditure rose across the world, the risk premium on sovereign debt shot up in the belief that some countries may not be able to service short-term debt. This is true of some countries in the euro zone, as they are finding it difficult to re-finance government debt without the assistance of third parties. The problems in the euro zone have persisted longer than expected and have now spread from peripheral regions to the core, as the major economies face a slowdown. The effects of sovereign risks on global banks have impacted the financial sector adversely as the increase in sovereign risks causes a loss on government bond holdings for banks. Moreover, banks are increasing their sovereign bond holdings of late in view of the preferential treatment for such securities under the Basel III liquidity standards. The highly interconnected and leveraged financial institutions have caused the risks to spread across the world, albeit indirectly. The recent Basel III guidelines requiring higher capital requirements may force European banks to de-leverage significantly. As per the final estimates released by the European Banking Authority, the region's banks need an additional capital of 114.7 billion euros by 30 June 2012. The de-leveraging of European banks will impact emerging markets including India.

The impact of the current financial crisis on Indian banks may be limited as they do not have much exposure to vulnerable countries. However, with the worsening of the European crisis, the Indian banking industry may be impacted as trade with European markets slows down. As liquidity pressures rise, Indian banks and companies will face challenges in refinancing their foreign currency liabilities. The European banks which have been actively participating in funding Indian companies through external commercial borrowings (ECBs) and trade credit over the last two years have a significant exposure to India. As per the latest Financial Stability Report published by the Reserve Bank of India (RBI), European banks' claim on India constituted 8.6% of GDP (See chart). However, some analysts estimate that the figure may have reached 15% of GDP. As European banks de-leverage, Indian companies will be forced to borrow from Indian banks at a higher cost, and domestic liquidity would need to refinance the shrinking overseas debt of Indian firms. This will put pressure on to the already tightening liquidity scenario in India.



Source: BIS Locational Banking Statistics and IMF

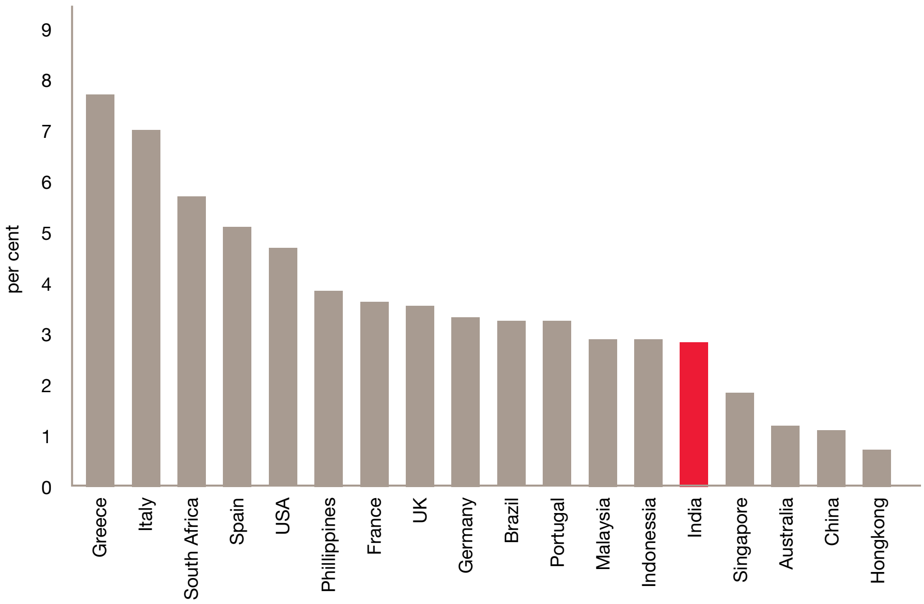
Consolidated foreign claims of European banks as a ratio of the nominal GDP

The situation, however, has been made worse by the slowing economy and inflationary conditions in India. The impact of rising global uncertainty and the depreciating rupee has adversely impacted the business climate in India. The high commodity prices and depreciating rupee have forced the RBI to take an anti-inflationary stand.

In the last few years, investors have been flocking to emerging economies like India due to their high growth trajectory and the uncertain growth in the developed economies. However, as countries like India fail to tame inflation, FIIs have been rushing to 'safe haven' assets like the US Treasury bills, US dollars and gold. While the FDI flows have not yet slowed down, FII flows have been moderated. The overall business climate, therefore, has not been conducive for growth, putting pressure on the credit off-take from banks. All these factors, along with rising levels of non-performing assets (NPAs), have impacted the performance of Indian banks adversely, though they appear to be healthier than their global counterparts.

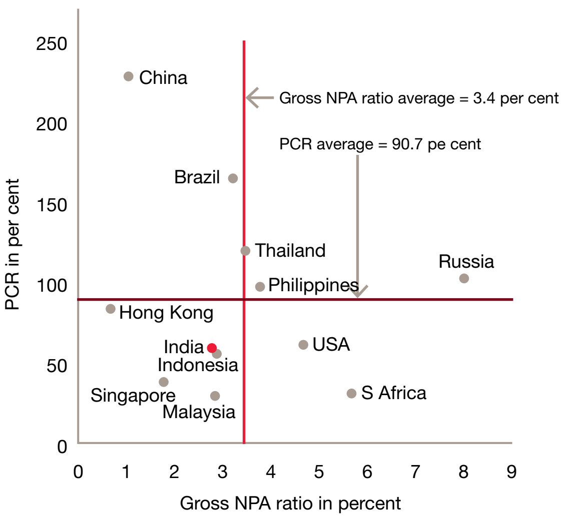
The civil unrest in West Asia against the incumbent governments is impacting governance and economic output. This has led to high oil prices even though the global oil demand has not risen significantly. Being a large importer of oil, India has been affected considerably. This, along with huge borrowing programmes for the social sector, will adversely impact India's fiscal deficit. The huge borrowing by the government will also put pressure on the liquidity conditions for the banks. The RBI has taken note of the tight liquidity conditions and has recently reduced the cash reserve ratio (CRR). It must be said that while Indian banks are still very sound than their western counterparts, signs of strain are becoming visible in the system.

Gross NPA ratios



Source: World Development Indicators (WDI), World Bank

Gross NPA ratios versus PCR



Source: Financial Soundness Indicators (FSI), IMF

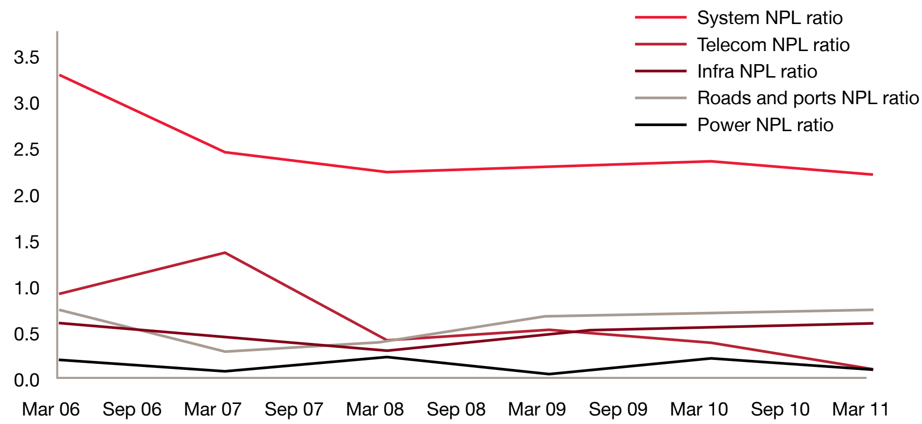
Impact of recent domestic issues

The slowing growth of the Indian economy has adversely affected the banking sector, which was booming during FY 2007-11 with credit growing by more than 20% CAGR and deposits growing at around 18 to 19%. In 2011, the RBI initiated monetary tightening through a series of rate hikes to contain inflation, which hovered around 9% during the year. The credit growth slowed down considerably in FY 2012 and was around 14 to 15% in February. However, by the end of March 2012, it rose to 19%, owing to increased borrowings by companies to meet their short-term funding coupled with government borrowing.

The impact of NPAs on the banks' balance sheet is significant. Gross NPAs have breached the level of 3%, with public sector banks bearing most of the brunt. Sectors like textiles, engineering, steel and construction are under pressure. Banks are also wary of lending to other troubled sectors like aviation, telecom and power, to which they already have sizeable exposure. As per the RBI, restructured and impaired assets in the power and telecom sectors represented 8.5% of the total restructured accounts in the banking sector in June 2011, rising from 5% in March 2011.The credit to the power and telecom sectors as of June 2011 contributed 55 and 22%, respectively, of the total credit to infrastructure, thus increasing concentration risks. The System Risk Survey conducted by the RBI in 2011 highlighted the deterioration in the asset quality as one of the biggest risks. Crisil estimates that the gross NPAs of banks increased to 2.9% of advances at the end of December 2011 from 2.3% at the end of March 2011 and that the quantum of loans restructured has shot up to 3.3% of the total loans from 2.5% over the same period. The RBI, in its Annual Policy 2012-13, has proposed that as bank branches are fully computerised, it will mandate banks to have the following:

- A robust mechanism for early detection of distress signs and taking measures, including prompt restructuring in the case of all viable accounts wherever required, with a view to preserving the economic value of such accounts
- A proper system-generated segment-wise data on the NPA accounts, write-offs, compromise settlements, recovery and restructured accounts

NPL in Infrastructure Loans (%)



Source: RBI, Fitch

The working capital cycles have become longer, investments in new capex have become slower with rising interest rates and weak liquidity in the system has led to deterioration in the finances of companies. With commodity prices showing no signs of easing, it has been a difficult year for most companies and their profitability has become doubtful. The RBI report on the financial stability of banks indicated that the illiquidity is at a high of 80%.

Gross bank credit of scheduled commercial banks to affected industries (Cr)

Industry	April 2010	June 2010	Sept 2010	Dec 2010	Mar 2011
Textiles	121,474	121,455	123,764	130,294	144,738
Engineering	72,254	75,770	82,987	88,993	93,367
Steel	129,443	136,677	137,588	150,603	163,189
Construction	43,615	44,260	42,661	44,676	50,135
Telecommunications	62,711	80,807	100,181	94,836	100,425
Power	196,552	209,073	227,523	245,980	269,196

Source: RBI

All of this has also been reflected in bank lendings. The impact of weakening corporate finances, like in the case of Kingfisher and Air India, on banks' balance sheets can be damaging. In absolute terms, it is estimated that the loans worth approximately 600 billion INR were restructured in 2011-12, taking the total portfolio of debt recast to 1.7 trillion INR. While the Indian banking sector is well capitalised vis-à-vis its global counterparts, an increase in sectoral NPAs can lead to significant capital requirements for some banks to maintain a high level of growth. With Basel III guidelines coming into the picture, the need for capital conservation will be high, and the environment must be conducive for banks to grow at a fast pace.

In response to the recent moderation in inflation and slowdown in growth, the RBI has taken the following steps to help the Indian banking sector to move to a faster growth track:

- Reduction in repo rate of 50 basis points, which may lead to improvement in credit off-take and moderation in NPAs
- Reduction in CRR from 6% to 4.75% in two steps, thus improving the liquidity of the banking system

Other measures that can help the banking sector:

- Forward-looking policy initiatives by the government such as allowing FDI in retail, pension funds and aviation and increasing FDI in insurance: this may increase confidence in equity markets and increase dollar inflows leading to rupee appreciation, which will help decrease inflation and take the economy on the growth path
- Banks finding ways to manage the sectoral NPAs better without hurting growth

However, in spite of these steps, the government needs to look at structural problems in the economy like supply-chain constraints in the food sector, improving fiscal deficit through optimised government spending (and therefore borrowing), deregulating commodities like petrol and diesel and developing mechanisms for improving infrastructure. This will definitely help the banking sector and lead them to the growth path.

Key regulatory developments impacting Indian banks

In the last couple of years, the RBI has taken some initiatives that will have an adverse impact and some that will have a positive impact on banks. Some of the key initiatives and their potential impacts are listed below:

Savings rate deregulation for banks in India: The RBI has deregulated the savings rate regime for improving the transmission of the monetary policy, as has been observed in peer economies like Hong Kong. It has also ensured that banks offer uniform rates across the country for different slabs they create. As savings deposit is the source of low cost funds, competition amongst banks will see an upward trend in deposit rates and will adversely impact the net interest margin for banks with high savings deposit as its core funding base. While a few private banks have offered lucrative savings deposit rates, the public-sector banks as well as leading private sector banks have not yet followed suit.

The deregulation of non-resident (external) rupee (NRE) deposits and ordinary non-resident (NRO) accounts, however, has led to severe competition between banks. As a result, savings rates have increased by 70-80%, hovering just below the fixed deposit rates offered. These accounts have significant and stable balances, thus ensuring a constant source of funding.

Savings deposit interest rates do not necessarily indicate the bank chosen by customers. However, the prevailing high inflation and possibility of savings bank portability may lure the customers to shift banks for higher rates, as has happened in the case of the telecom sector.

Implementation of base rate for lending: This has led to enhanced transparency in the banking segment, as banks cannot lend below the base rate to new borrowers.

Provision coverage ratio (PCR) of 70% mandatory for banks: The RBI has mandated a PCR of 70% for banks; this will raise the provisioning requirements for some banks. However, the impact is partly nullified by the fact that technical write-offs can now be included in the PCR calculation.

Basel III guidelines: The RBI has announced Basel III guidelines for scheduled commercial banks. Preliminary estimates show that banks will require significant additional capital for implementing Basel III guidelines. Higher capital and liquidity requirement will increase the cost of capital, thus putting the banks at a disadvantage.

Relaxation of branch authorisation policy for Tier II cities: Domestic Banks can now open branches in Tier 2 cities under general permission of the RBI. This will help increase bank penetration in these areas. Banks can now open branches in Tier 2 to Tier 6 cities, thus improving financial inclusion.

Relaxation of mobile payment guidelines: The RBI has removed the transaction limit of 50,000 INR per customer per day on mobile banking and has allowed the banks to decide transaction limits based on their own risk perception. This will help the banks to use mobile banking as an effective alternate channel for large fund transfers; however, they have to put strong anti-money laundering (AML) systems in place.

Issue of final guidelines for new bank licenses: With the new banking licences on the anvil, competition in the banking sector will increase with new participants and encourage financial inclusion.

Subsidiary route for foreign banks: RBI is likely to make it mandatory for large foreign banks in the country to operate as wholly-owned subsidiaries, in line with the international practice, so that the central bank can have better control over their working and ring-fence operations in India based on global developments.

However, from a long term view, it can be said that in a growing economy like India, the current slowdown in credit may be a temporary phase for Indian banks. They also need to look inwards to have better risk and effective long-term cost management strategy with a continuous focus on improving share of fee income, which will help them to tide over the crisis.

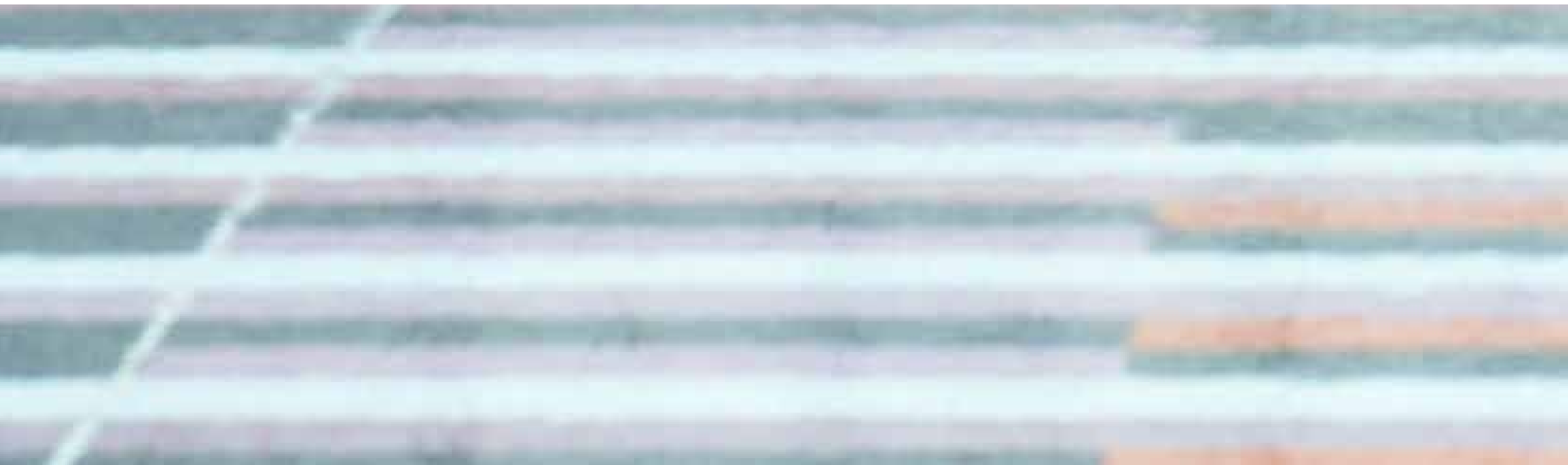
Drivers for future growth

Indian banks can move to the next level of growth if they are assisted by some key drivers. PwC has developed a framework called Project Blue, which assesses the future of financial services and considers the major trends that are reshaping the global economy and transforming the behaviour of consumers, businesses and governments. The global trends coupled with the local realities will drive the progress of Indian banks.

Our research shows that, globally, there is a broader set of drivers that have the potential to change the industry. Managing against these drivers will provide an opportunity to get ahead of the curve.

Short-term drivers (1-2 years)	Medium-term drivers (2-5 years)	Long-term drivers (5-20 years)
Industry size relative to GDP	Technological change	Rise of SAAAME - South America, Africa, Asia and the Middle East
Fiscal pressure	Talent drain	Demographic shift
Regulatory reform	Changing customer behaviour	War for resources
Stakeholder trust	Treating customers fairly	Rise of state-directed capitalism

Source: Project Blue, PwC Research



In India, however, the medium-term drivers will be key determinants for Indian banks as they prepare for a longer-term strategy. Some of the most important drivers for the next 2-5 years are as follows:

Technological change: Technology will enable Indian banks to reach out to masses in a cost-effective manner. It will remain a key driver for multiple-channel integration, product and process innovation, financial inclusion and risk management.

Talent drain: The supply-demand mismatch of talent in the high growth banking sector will adversely impact the banking industry. Natural attrition in the public sector banks will intensify the competition for talent.

Changing customer behaviour: Customers are more aware of their needs and are becoming more demanding with time. With the number of young customers on the rise, banking experience and alternate channels will be a key driver in the Indian markets.

Treating customers fairly: The RBI has been taking several steps to ensure transparency in service charges. Financial inclusion is a focus area for the RBI and banks are being continuously encouraged to provide more inclusive banking services, particularly to customers who are traditionally viewed as unprofitable.

The long-term drivers for Indian banks will be a natural progression from the medium-term drivers. Some of the key drivers will be as follows:

Rise of SAAAME (South America, Africa, Asia and Middle East): Scheduled commercial banks saw tremendous asset growth (around 20% CAGR) during FY 2008-11. Large banks have opportunities to expand their global footprint in the emerging economies to de-risk their balance sheets. Banking licenses to new operators will increase competition and strengthen the Indian banking sector.

Demographic shift: Nearly 35% of the Indian population has a median age of 25.5 years, which signifies that India will gain from the demographic dividend. Use of alternate banking channels like ATM, Internet and mobile channels will increase manifold to reach out to these young consumers. Banks need to develop specific products based on the lifestyle of these young consumers in order to lure them.

War for resources: High growth has given rise to a supply-demand mismatch, leading to inflationary pressures, particularly food inflation. Dependence on oil imports will impact India's growth and hence the banking sector.

Rise of state-directed capitalism: The RBI has been proactive in terms of monetary policy and prudent with respect to risk management for banks. Disclosure requirements have become stringent over the years and are expected to remain so.

Need for a customer - centric model

Banks are facing challenges as customers have become more demanding and their loyalties are diffused with low-switching costs. In India, recent RBI initiatives like savings-account portability, zero-balance account with minimum facilities, withdrawal of penalty for foreclosure of home loans and savings rate deregulation will have an adverse impact on banks' operations and their ability to retain customers.

We believe that there are five key aspects of changing customer behaviour, which will make banks think about engaging more with the customers.

Moreover, customer expectations for banking services (both offline and online) are being reset by the experiences being provided by retailers and online providers elsewhere. Today, the economic climate, increased regulatory intervention and competitive challenges are forcing banks to de-leverage and look for other sources of value.

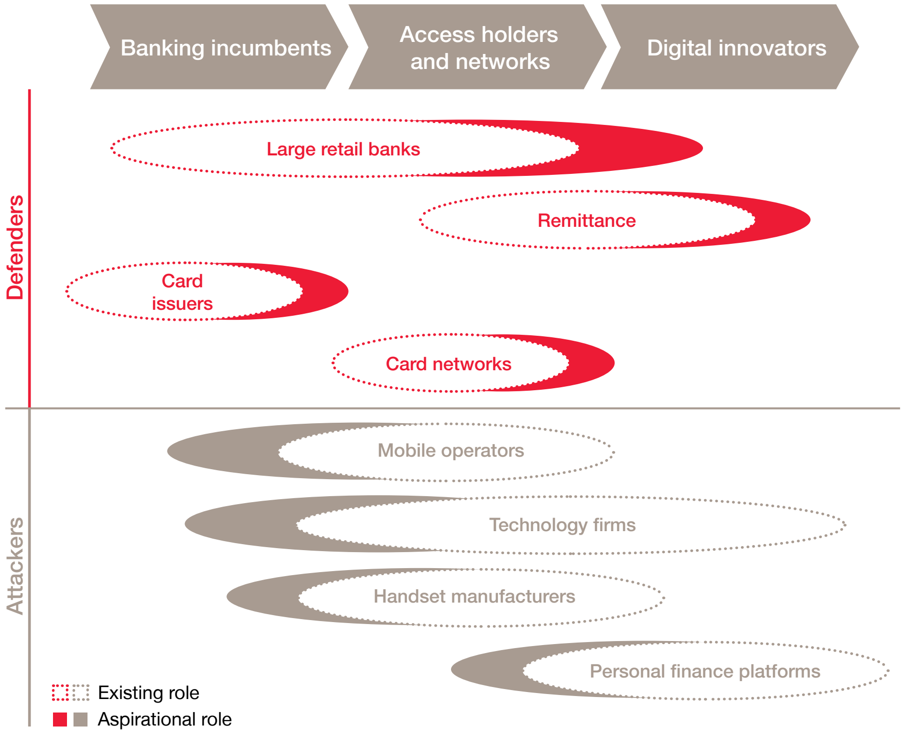
Customers				
...expect more	**...trust their peers**	**...are informed**	**...have choices**	**...have a voice**
Expectations are being shaped by experiences outside the banking industry, where content, interactions and features are richer, delivering a more engaging and rewarding experience for the consumer.	The role of banks as the financial experts has been replaced by 'word of mouth' peer conversations, or independent influencers. The rapid emergence of social media in parallel with the rise of mobility has seen customers increasingly turn to their peers for information and advice, rather than to financial experts in banks.	Financial consumers are savvier today, due to the easy access to research, data and 'expert' views. This has also exposed the lack of differentiation between the banking products of different providers. As more financial services customers become 'self-directed', customers are coming to rely less on traditional sources of financial advice.	Comparison and purchase of alternative financial products and services online is now straightforward and widespread. It has opened up a wide range of choices for consumers, some outside the boundaries of traditional banking services, such as peer-to-peer lending.	The rise of social media platforms has allowed a single consumer voice to be amplified to a tremendous degree, and consumers have not been shy about raising it. Stories of bad customer experiences rapidly spread through these media and often cause irreparable damage to associated brands.

Source: The Digital Tipping Point, PwC publication

Our analysis of the banking ecosystem shows that there are both 'defenders' and 'attackers' in the market. 'Defenders' are market incumbents that have traditionally controlled their own segments in the banking value chain. While almost all of them aspire to move into the digital innovator space, few are equipped to do so without external help (through acquisition or partnerships). 'Attackers' are new entrants who are trying to wrest share away from the incumbents by intermediating themselves into the value chain. These include established players in the technology and mobile sectors as well as smaller and more nimble start-ups. We believe that while these players may be able to secure positions on the value chain, they are not likely to displace banks as the primary provider of financial services.

Therefore, it has become imperative for banks to become more customer-centric to defend themselves from attackers and retain market share.

With minimal product differentiation, it is important for banks to engage customers with emphasis on services to retain old customers and attract new ones. A business model that aligns itself with customer requirements is the need of the hour. The shift to a customer-centric model will ensure that banks can quickly differentiate from competitors who tend to work in silos. Across the world, leading retail banks are learning more about customer needs, wants and expectations in a bid to boost sales. Rather than investing in a high volume of advertising to the masses, leading banks are emphasising on 'contact optimisation.' Besides, mobile technology and social media are presenting new opportunities as well as challenges for retail banks..



Source: The Digital Tipping Point, PwC publication

The retail banking model, over the past decade, has matured and banks have been able to provide a range of products. However, to satisfy consumer needs and build a genuine, productive relationship, banks need to align their product and service offerings against the customer lifecycle—both the day-to-day transaction needs and the infrequent but imperative 'moments of truth' (e.g., buying a home, funding college, etc.).

A customer-centric model can provide the following benefits to banks:

- Reduced cost-to-serve by integrating customer service processes end-to-end
- Increased customer retention through convenient, consistent and personalised service
- Increased cross-sell rates through improved customer knowledge, enabling relevant offers to be made via the most appropriate channel
- Reduced time-to-market for introducing new products
- Improved operational efficiency by bridging automation gaps and standardising on best-in-class practices across different channels and product lines

Major challenges

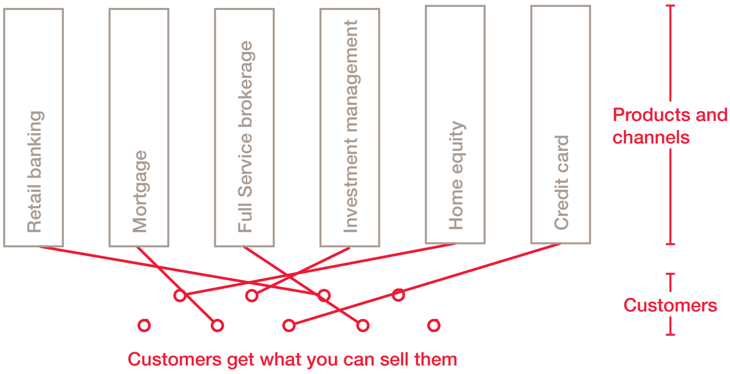
Integration complexity: To consolidate the disparate technology platforms and operations of multiple product lines is a highly complex process fraught with execution risk. It may be difficult to reconcile diverse and often conflicting business and technology requirements of various product groups. As product features and functions are designed with consumer experience in mind, individual business units lose absolute control over the product development process in a multi-product, customer-centric world.

Conflicting priorities: Product-line investments, revenue and cost allocation models do not support multi-product or entity-level projects that might improve operational efficiency and organisational profits (e.g., shared underwriting and marketing processes for credit cards, auto loans and home loans). Instead, incentives tend to fund and implement projects within silos. Thus, it drives the market share and profitability of each silo rather than the organisation as a whole.

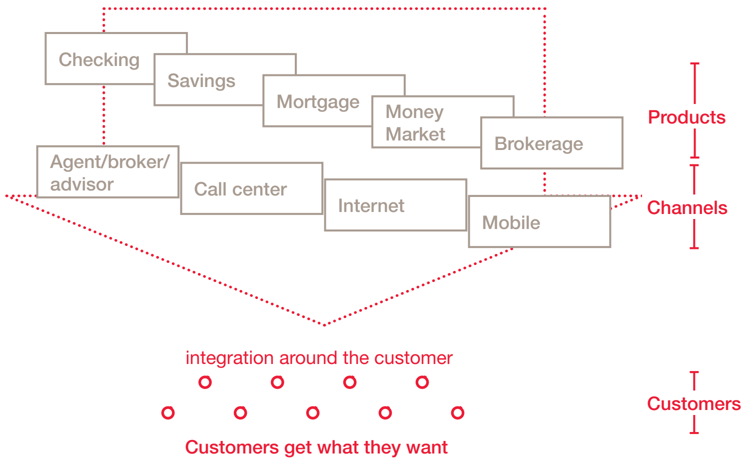
The traditional banking model, structured around internal product groups (silos), is organisation-centric. It prevents banks from understanding the products and services their customers have purchased across the enterprise. In this difficult economic environment, product silos are struggling to stay profitable. In our view, banks should adopt a new, customer-centric model integrated around customer needs.

To adopt a more efficient customer-centric model, the key is to develop an open and successful relationship with the customer, deliver an effective value proposition throughout the customer lifecycle and back it up with good customer service. Trust levels are very important in a banking relationship as the customer wants sound advice and good services.

Organisational centric traditional model



Customer centric new model



Following are the key elements of an ideal model:

An effective customer management information system: Historically, customer information is account-or product-centric. However, it needs to be customer-centric. Banks need to integrate customer data, systems and processes across the different product lines to update relevant customer information. However, customer relationship management tools are more focussed on the transaction history of customers. Banks need to constantly engage with customers to understand their needs (e.g., wealth goals, level of financial sophistication, etc.) and connect it with their transaction history. Customers will continue to give more information about themselves only if it creates value for them. Therefore, banks need to move beyond event marketing and become financial advisors to the customer during the lifecycle.

Integration of multiple channels: Customers want to interact with their bank using a variety of channels. However, over time, channel growth and expansion has led to multiple silos of channel-specific customer data and lack of integration between channels as they are often managed separately. The result is little or no sharing of information across different channels, duplication due to channel-specific processes and a disjointed, unsatisfactory multi-channel experience for the customer. Banks can achieve tighter co-ordination and integration of their channels so that customer interactions can be managed, tracked and completed across multiple channels. E.g.,, a customer can initiate an activity such as applying for a loan via one channel and complete it using another.

Intelligent cross-selling: Banks can improve customer information management, multi-channel integration and operational efficiency to use as an effective tool to cross-sell new products to existing customers. They can then use predictive modelling techniques to utilise customer and real-time information better to predict the next best product for the customer. Understanding the customer-cycle and their real-time needs will help banks offer additional products or services only if they are relevant and suited to customers and can help create a win-win situation for both i.e., increasing customer satisfaction as well as customer value.

Digital innovations: Finding new frontiers of inclusive growth

The last few years have seen increasing use of technology by Indian banks. The core banking implementation in the country has been a key enabler to reduce costs and increase efficiency. Our analysis during BW PwC best bank survey showed that banks spend around 15% on technology. The spending on banking technology is expected to be around 20% of the total expenditures by banks. According to a study conducted by Frost & Sullivan (F&S), the spending will increase at an annual rate of 14.2%.

Banks are now able to manage increased business and transaction volume with lesser manpower thereby reducing costs at the operational level. The reduced dependency of banks on diverse human efficiency has led to standardisation in the quality of service, leading to increased efficiency and competition. The implementation of core banking technologies has led banks to offer multi-channel banking facilities. They have been able to utilise technology, in back-office processing, convergence of delivery channels as well as IT-enabled business process reengineering. Banks can now require less incremental capital to expand their network with the help of data communications and the ability to automate key processes.

One of the most visible benefits of deploying core banking has been collating customer information and using it to offer customised services. However, banks have not been able to derive the maximum benefits and have a long way to go. Our interactions with leading banks, particularly public sector banks (PSBs) reveal that only 60 to 70% of core banking has been utilised, mainly benefiting from a transactional point of view. However, banks are yet to fully maximise the singularly integrated view of customer information available within core banking systems. An analysis of the core fee income for banks shows that leading private sector banks have nearly 18 –to 20% while for public sector banks, it is around 8 to 10%.

Cost to income ratio				
Type of banks	FY08	FY09	FY10	FY11
Public sector banks (PSBs)	48.0%	45.5%	46.2%	45.3%
Old pvt sector	47.3%	45.1%	49.3%	48.4%
New pvt sector	51.2%	47.9%	42.7%	45.0%

Source: PwC analysis, RBI, IBA

The ability of banks to utilise customer information, using analytical models to get a holistic picture of the customer lifecycle will enable them to offer value-added products and services and differentiate themselves from second-tier banks. Digital innovations will play an instrumental role in customer relationship primacy (the position of being the preferred and main bank for a customer) in the coming years. Our survey, The Digital Tipping Point, pointed out that the preference for digital is now pervasive across all customer segments, globally, especially so for the Gen Y (in India this is the age group between 18 to 35 years). The group is at the threshold of deciding primary banking relationships (the quality of the digital offering is an important factor in their decision process). Banks have to act now to attract these customers. The digital strategies will need to move beyond cost reduction objectives to do this.

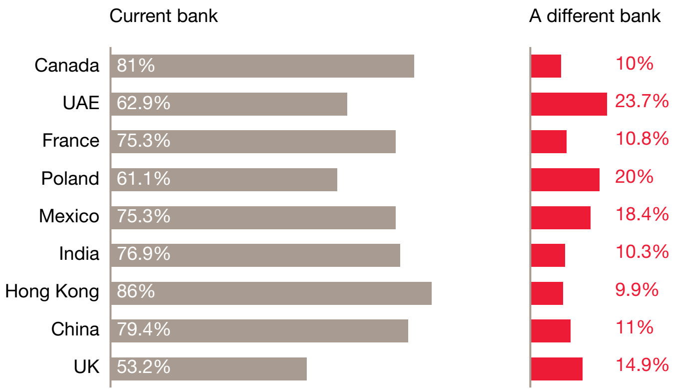
Our research revealed that there is a high correlation between digital engagement and the economic status of the customer. Digitally active customers tend to have large product holdings. We also found that primacy in a banking relationship drives increased the share of wallet leading to higher revenue generation from the customer pool.

Following are the four main considerations for a bank to invest in a robust digital offering:

1) A number of factors are influencing customer attitudes and behaviours.
2) The preference for digital banking is globally pervasive.
3) Digital is an important factor in the decision making process of generation Y, who are at the point of choosing their primary financial service provider.
4) Digital is evolving with a new set of disruptive features.

Primacy drives share of wallet

“If you were going to purchase a new banking product, how likely are you to buy from the following?”

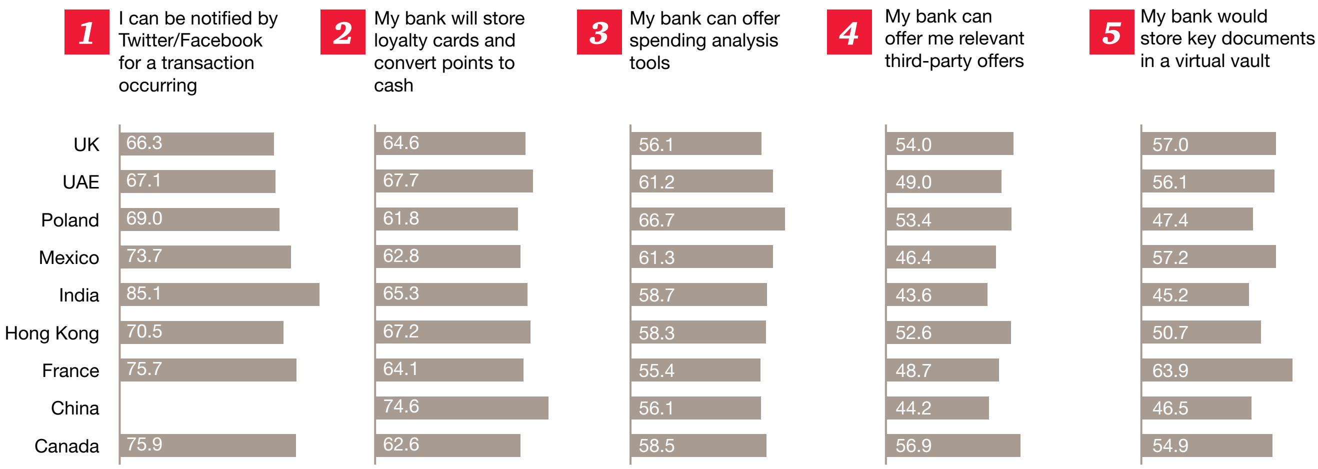


% of respondents that chose current banking provider or another banking provider in response to the question. Other options included a provider that is not a bank but has a physical presence (e.g. a supermarket chain) and an online provider.

Source: The Digital Tipping Point, PwC Publication

Appetite for innovative digital services

'Which of the following would you be willing to pay for, please rank your top 3?'



Level of interest [Scored ranking results (rank 1=100, 2=50, 3=25); average 0-100]

Source: The Digital Tipping Point, PwC Publication

Digital banking will provide new value for banks and their customers through a new 'digital feature set', based on innovations in user experience, mobile devices and networks, social media and collaboration, customer analytics and channel integration. By embracing digital, banks can strengthen their existing customer relationships as well as access new sources of revenue. Our research suggests that the extent to which a bank exploits the new digital feature set will play a very important part in gen Y's decision making process rather than the traditionally important criteria such as branch location or even brand.

The new digital feature set has led to the following:

- Improvement in user-experience design through interactive, game-like interfaces that are starting to merge the boundaries between the real and virtual. They are also bringing data to life through rich visualisations.
- The advancements in mobile devices and networks are providing new services such as enhanced digital security and the ability to access the Internet from anywhere (partially limited by high international roaming charges).
- The rise of social media and collaboration tools are empowering customers and employees and moving control of the 'brand message' from businesses to consumers.
- Innovation in digital analytics and predictive models are driving deeper insight into customers' behaviour and enabling highly targeted and relevant treatment strategies to be executed through digital media.
- New channel integration technologies are enabling a more seamless end-to-end experience for customers with their bank.

The shift to digital channels has opened up new opportunities for banks to engage and interact with customers to build relationships and grow revenues. For banks that managed to create a similar shift in their own distribution models, similar opportunities await.

Power of social media

Social media can help banks engage with customers in a more informal way and provides the perfect platform for brand differentiation. The primary objective is to listen to the needs and grievances of consumers. In a country such as India, where 50% of the people are unbanked and also majority of them do not have online access, this may seem a little premature. However, the growth of online and mobile customers in the country is one of the fastest in the world. Thus, the investment in this medium provides a perfect platform to reap its benefits in the future.

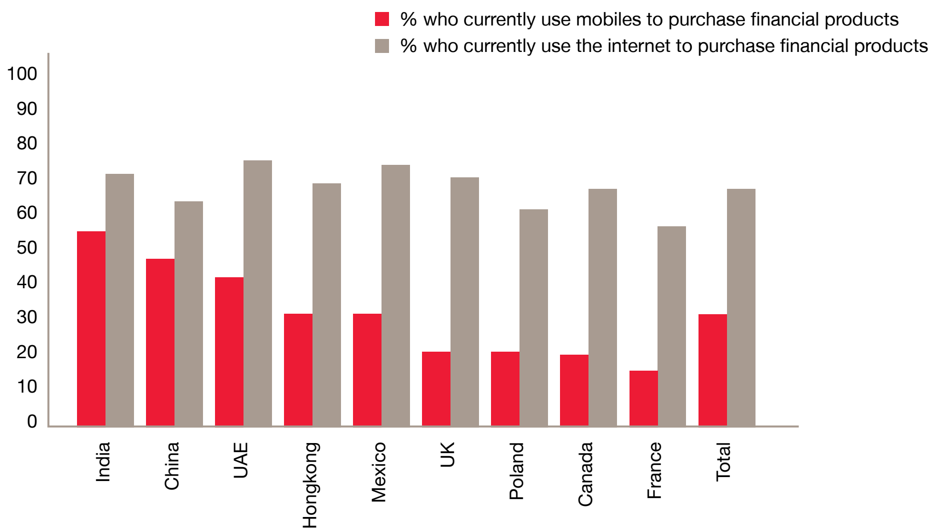
The proliferation of social media has taken word-of-mouth marketing to exponential levels. Customers are using this platform to actively spread the word in real time about their customer service experiences. The average Facebook user has 150 friends who can find out about a bad banking experience within seconds, and well-treated customers are becoming unofficial mouthpiece for certain brands. Banks must respect the power of social media (they can build or tarnish reputations) and focus on delivering quality services. It is better to invest in processes that anticipate issues and address them immediately than to learn about a problem after it is featured in a blog.

Banks need to have a social media strategy before they go online. They need to be proactive in interacting with customer and understand their choices and preferences. It can also help them to map consumer trends through this and develop products and services accordingly. Banks need to understand customer segments, their usage of social media from a technology and interaction perspective and their implications. Banks can use the channel to create innovative products and services that reflect real time consumer demand. Internationally banks have developed online communities which have helped create specific products for particular needs. As we evolve in the path of digital evolution, there will be a time when financial products will be co-created with the help of customers.

Social media can also help banks in optimising costs in relation to sales and services as it provides an interactive and low cost medium to broadcast messages, identify dissatisfied customers and have a great impact than traditional media particularly amongthe urban youth

In India, several banks such as ICICI, HDFC, IDBI, etc. have moved to Facebook and Twitter. IDBI, a public sector bank, has been able to gather mind space in a short period of time with an interesting mix of informative content, product awareness and grievance redressal. However, Indian banks still treat social media as a customer grievance and product marketing forum, rather than a platform to engage with customers providing perspectives on industry, seeking feedback to develop new products and sharing insights about operating environment around a branch.

The global usage of internet and mobile usage in banking



Source: The Digital Tipping Point, PwC Publication

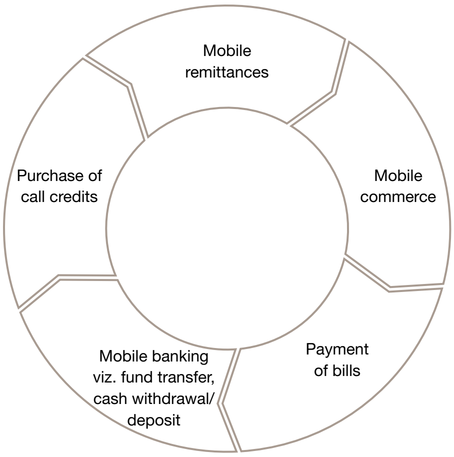
Evolution of mobile banking

The growth of mobile has significant implications for banks. As mobile phones get equipped with more and better functions, it will transform the traditional interaction model with the consumer. Well-appointed branches and slick websites will no longer be enough, as customers expect services on the move. Location-based offers, timely and relevant content and interactive applications will form the basis of the mobile customer's engagement with their banks.

The Internet is widely used by all banking segments around the world to purchase financial service products. Mobile banking is still in its infancy, but is following a similar usage curve with China, India and the UAE leading the pack. For the emerging markets, mobile is more than just a new channel, as it provides basic banking facilities to a previously under-banked market.

The Indian regulators have taken a series of steps to enable mobile payments which forms one of the important cogs in mobile banking. Unlike countries such as Kenya, the country's delivery model for mobile financial services will be bank-linked. Therefore, banks become an important partner to create an ecosystem to deliver a whole range of financial services. They need to constantly innovate and provide mobile solutions to the Gen Y customers as expectations grow faster.

Key services provided across the world:



Mobile banking transaction costs are expected to be similar to the Internet banking transaction costs. By 2015, it is estimated that the mobile transaction volume worldwide will reach US$ 500 billion. PwC estimates mobile banking transactions in India will exceed 340 million in 2015, resulting in cost savings of approximately (INR 11 billion) 1,100 crore INR.

Cloud computing

This is one set of digital innovation that can change banking in the coming years, if used properly. It enables banks to respond quickly to the rapidly changing customer requirements with less amount of incremental investment in technology as cloud is available on-demand. It helps banks to become more agile and create a developmental environment in less time and operational requirements.

While it seems the most attractive part of cloud computing is to bring cost efficiencies, it can also make banks develop customer-centric business models through faster and efficient response and by developing new products and services quickly. Some of the key benefits that emanate from cloud based business models are the following:

Flexible operating models: The cloud computing model can bring out innovations in products and services which can be introduced in a short period of time based on customer needs and preferences. It provides an ecosystem where banks can efficiently manage its operations across the value chain.

Enhanced customer centricity and experience: As customers become more demanding and their needs become complex, banks need to differentiate themselves through enhanced service delivery and improved transparency. Cloud-based analytics can help banks to optimise costs and also gets a single integrated view of the customer to facilitate the decision making process. It will also enable them to increase speed and responsiveness in test and development environments. This will enable shorter time-to-market and greater flexibility for new products and services. Also marketing campaigns can be effectively delivered through cloud-based web hosting and dynamically refine it based on real time market trends.

Banks can now engage customers by providing innovative products through the Internet and social media including analytics, improved information and access accounts tuned to the need of consumer and commercial customers. Cloud can also provide 'one view of the client' in a cost-effective manner without costly integration and upgrade challenges and help the banks in cross-selling.

Faster time-to-market: It can help reduce the time-to-market from months to weeks by reducing procurement delays for IT infrastructure, reducing time for application development and expediting computing power for existing applications.

Optimising infrastructure costs: The virtualisation of data centres, local networks, etc. can substantial save costs for the bank. Also, standardised integrated platforms can lead to scalability across the bank. Banks can derive significant competitive advantage through high availability and centralised management across numerous applications.

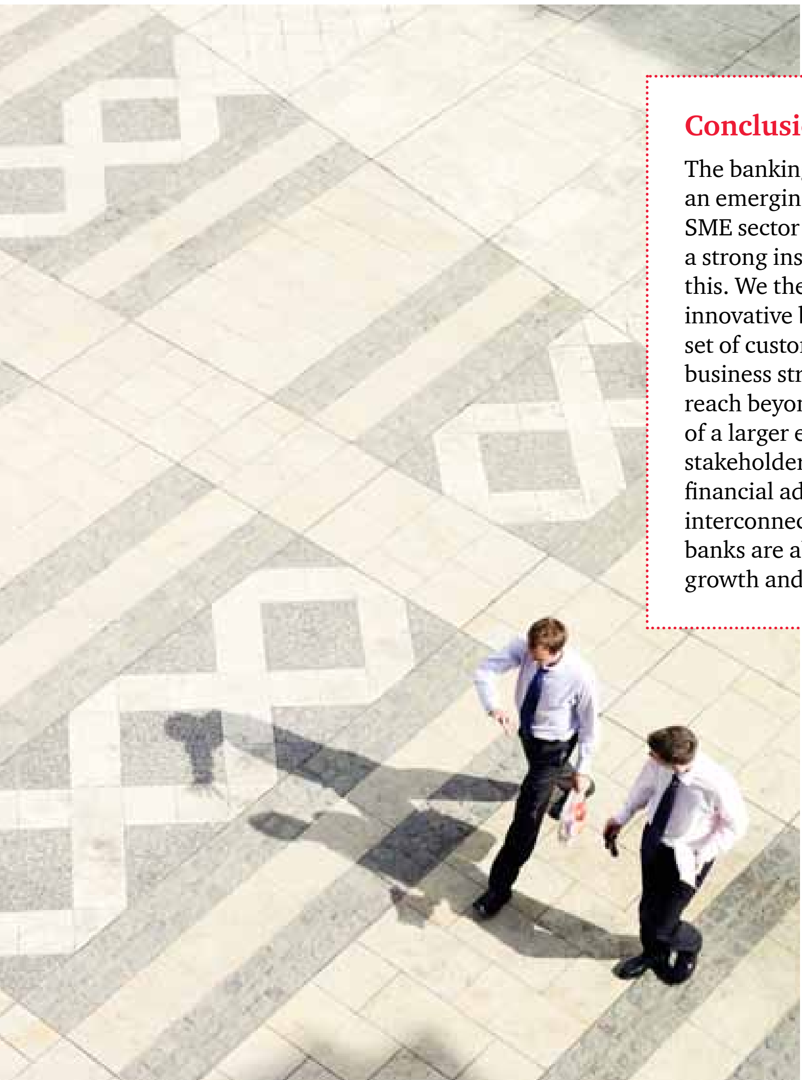
In India, banks are yet to take up cloud computing due to security concerns and the on-going analysis on cost benefits. However, sooner banks will adopt these new technologies to improve their services and respond faster to customer requirements.

Improving penetration

In the last few years, India's economic growth has resulted in an increase in disposable incomes leading to a surge in demand for both corporate and consumer financial services. Core banking has helped banks to reach more usefully to the unbanked poor. With new technologies such as smart cards, mobile ATMs, virtual banking (banking through the Internet), banks are now in a much better position to cater to the economically weaker section. PSBs are the most effective as they already have strong branch networks. Our technology survey from BW-PwC best bank survey showed that the use of Internet banking has increased to around 10% in 2011 from 6 to 7% in 2010. Though still at a nascent stage, mobile banking is increasing at a fast pace. The efficient use of low cost technology will enable Indian banks to not only execute financial inclusion but also add to the topline.

Today, banks have products but not the distribution network. This gap can be reduced with the help of mobile networks. Currently, money transfers, payments and banking can take place over devices. The World Bank estimates that banking penetration among middle-and high-income groups is 45% and less than 5% among the low-income segment in emerging markets. With unique identification number coming in full-force in the next couple of years, mobile can be an effective way to transfer funds in the rural areas. Mobile remittance provides a big opportunity where mobile network operators forge partnerships with banks or RSPs to efficiently handle cash management and disbursement. Banks exploit the distribution reach of mobile networks to market services among underpenetrated customer segments while mobile network operators benefit from the banks domain expertise.

However, the value chain for this is little complex with incorporating wholesale arrangements between mobile operators and financial service providers on the one side and the retail distribution network that serves customers, on the other. However, an effective regulatory structure can help and it will ensure a range of solutions efficiently, securely and at minimal cost, resulting in services being substantially more widespread, inclusive and sustainable.



Conclusion

The banking sector acts as the barometer for the economy at large. For an emerging economy, where credit dispersion is often a challenge in the SME sector and intermediation between savers and investors requires a strong institutional set up, commercial banks acts as the bulwark for this. We therefore need strong banks which are well capitalised, with innovative business models purveying products and services to a diverse set of customers. In an increasingly digitised world, banks need to adopt business strategies built on a scalable IT platform which allows deeper reach beyond tier II cities and manage cost structures well. As part of a larger ecosystem where banks have to identify the most relevant stakeholders (including telcos, banking correspondents, independent financial advisors and any supply chains) an appreciation of their interconnectivity, can help connect the dots. It remains to be seen which banks are able to see through all of this and identify new frontiers of growth and contribute more substantially to the economy.

About ICC

Founded in 1925, Indian Chamber of Commerce (ICC) is the leading and only National Chamber of Commerce operating from Kolkata, and 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 it's President.

ICC is the only Chamber from India to win the first prize in 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 offices in New Delhi, Guwahati, Patna and Bhubaneshwar functioning efficiently, and building meaningful synergies among Industry and Government by addressing strategic issues of national significance.

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