Opportunities for Action in Financial Services

India Beyond Outsourcing: The Opportunities for International Banks

The Boston Consulting Group

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India's banking market is one of the fastest growing in the world. The reasons are numerous: a burgeoning national economy, financial-sector reforms, foreign investment that has risen in step with an easing regulatory climate, and a highly favorable demographic profile, to name a few.

Some leading international banks have already demonstrated that it is possible to establish a presence in India and achieve profitable growth amid local competition. But India's potential is so vast that significant opportunity still awaits foreign banks that have not yet explored the country. It is an opportunity that few can afford to ignore.

Fueling India's banking growth is a greater than $600 billion economy that is expanding at about 6 percent per year, stimulating per capita incomes and consumption. Large numbers of households are shifting into the middle class, creating booming markets in housing, motor vehicles, televisions, computers, mobile phones, and other products—most of which require financing. Total banking assets have doubled over the past five years, and industry profits have tripled over the past three years. The current profit pool of about $4.8 billion could climb to $20 billion by 2010 and may reach $40 billion within a decade—resulting from a rapid expansion of revenue that will parallel that of the overall financial-services sector.

What is more, about 60 million new households should be added to India's bankable segment by 2009. And the country will likely have a surplus of 47 million people aged 15 to 59 by 2020—a time when most other large economies will face a shortage in this age bracket. Infrastructure gaps, although glaring in some areas, are improving, and a stable political-reform consensus bodes well for continued economic growth.

Of course, entering India's banking market is no small task. More than a few foreign institutions have tried to secure a foothold, found the going slippery, and departed with not much to show for their effort and investment. But the fact that success is attainable should make international banks take notice: India in the twenty-first century is about far more than outsourcing and offshoring. The 33 foreign banks currently doing business in India collectively earned more than $500 million in aftertax profits in 2004, with the three most established players accounting for most of that profit. For some foreign institutions—Citibank and Standard Chartered Bank, for example—India is the most important emerging market, providing even higher returns than their home countries.

Given India's potential over the next decade and beyond, it is imperative for international financial institutions to consider entering the country. Moreover, foreign banks already present in India should explore ways of expanding onshore in order to ride the growth in the domestic market. Naturally, part of any bank's debate about India should begin with an exploration of where the country's best opportunities currently lie.

Opportunity Knocks

Retail financial-services businesses—such as mortgages, personal loans, wealth management, and asset management—have enormous potential in India today, given their relatively low levels of penetration.

Retail lending, for example, at about $40 billion in 2004 and growing at roughly 30 percent per year, still represents only about 20 percent of industry advances and less than 7 percent of GDP—a much lower percentage than in Thailand (18 percent), Malaysia (33 percent), and South Korea (55 percent). India's demographic profile makes it likely that this rate of growth will continue for the foreseeable future.

Consider India's mortgage business. Bolstered by low interest rates, mortgages currently account for half the retail asset market. And there is significant room for further development, with volume rising possibly to $50 billion within the next few years. Or take the wealth management sector. India is among the top six Asian countries in terms of net investable assets (NIA). According to various estimates, there are around 400,000 Indian households with NIA above $250,000, 150,000 households with NIA above $500,000, and more than 60,000 households with NIA above $1 million.

In the broader asset-management arena, the roughly $35 billion in assets being professionally managed in India is quite low, representing just under 6 percent of GDP. Nonetheless, the value of assets managed by private and foreign-owned players (which now account for more than 75 percent of the market) has grown by 60 percent annually over the past five years. With more than $180 billion in long-term fixed deposits in banks and low penetration in the pension market, sustained growth is expected. What makes the opportunity especially attractive is that many private institutions above a certain critical mass are earning a return on equity of more than 30 percent.

India's billion-strong population, demographic profile, and rising degree of affluence also bode well for other retail products currently in their infancy, such as credit cards and life insurance. India's credit-card base has risen to about 10 million, for example, but only two players are earning appreciable returns. Moreover, since the insurance sector opened up, growth in new premiums underwritten by private players has increased from $56 million in 2002 to $550 million in 2004. Yet penetration still lags that of most emerging markets, and life insurance is just beginning to shed its image as solely a tax shelter. With a regulatory limit on foreign ownership of 26 percent, most domestic private-sector life insurers—amid explosive growth in the sector—involve alliances with international players such as Prudential UK, MetLife (UK), Bajaj Allianz, and Royal & SunAlliance Insurance.

The Peculiarities of the Indian Market

India's growth story is unfolding across a business landscape that has more than a few special features, which international banks should be aware of.

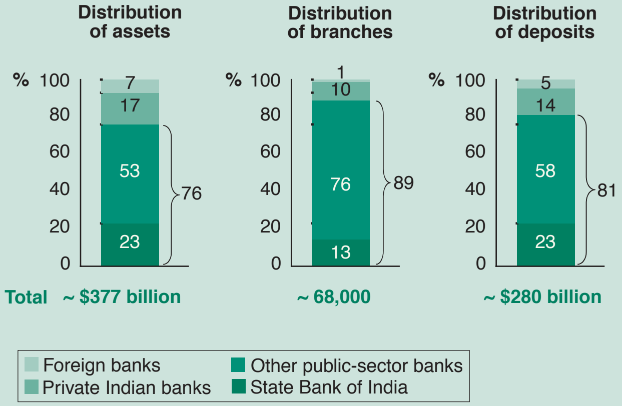
The first concerns the overall structure of India's financial-services industry. Long-entrenched state-owned institutions are the incumbents, dominating business within most segments. (See the exhibit "Public-Sector Financial Institutions Dominate the Indian Banking Landscape.") But these institutions are deeply constrained in their autonomy and in their ability to adhere to a market-based human-resources strategy. Moreover, in the short to medium term, they are not likely to be available for acquisition.

Second, the bulk of the Indian financial-services industry is concentrated in urban areas. Indeed, there are really two ways to look at the Indian market: inside metropolitan areas and outside their boundaries in rural regions. Most of the recent growth has come in urban areas, with the 20 largest cities currently accounting for 50 percent of the financial services market. Similarly, 80 percent of housing loans originate in 20 percent of the country's urban residential districts. Markets outside metropolitan areas have not yet been fully explored.

Third, banks in India typically have a very high volume of small transactions, requiring an operating platform that can support very low breakeven levels. The global operating platforms of international banks appear to be disadvantaged compared with those of new private-sector players that have entered the market since 1994.

Fourth, India's information infrastructure is still evolving. Information capture, especially with respect to risk, is gradually getting more attention as banks embrace technology. For example, a credit bureau for

Public-Sector Financial Institutions Dominate the Indian Banking Landscape



SOURCES: Reserve Bank of India; BCG analysis.
NOTE: All figures are from financial year 2003.

retail businesses has just been set up. Yet banks have to use considerable finesse in working around the problems that still exist in this area.

Doing Things Right

It is critical to note that the twists and turns on the road to success in India—although tricky to navigate—have not prevented some international banks from proving that they can arrive in the country, set up shop, compete with local players, and be profitable. Consider two noteworthy early entrants to India: Citibank and Standard Chartered Bank. Their success at tapping the country's potential in the offshoring and outsourcing arenas has overshadowed their remarkable achievements in the domestic banking market, where they have taken leadership positions in particular market segments.

Citibank has 35 branches in 25 cities across India and coverage of more than 50 cities through a distribution subsidiary. It is active in most retail, corporate, and investment banking services, and has turned a relatively modest investment in India into a $7 billion asset book and more than $200 million in aftertax profit in 2004. With an impressive return on assets (ROA) of more than 2.5 percent, India is clearly a key franchise of Citibank.

Initially, with a limited number of branches, Citibank focused on niche segments. Over time, it captured 35 to 40 percent of India's credit-card profit pool. It also went after select small-to-medium-enterprise clusters, retail assets, and investment services for retail customers. Citibank today is moving away from this niche strategy toward a more widespread, mass-market business model and has very ambitious growth aspirations. Elements of the institution's success have included its careful choice of profit pools to enter (and exit), innovation in product design and in the use of technology, and deft harnessing of India's managerial talent pool.

Standard Chartered Bank is the largest international bank in India today, with 76 branches and 158 ATMs in 26 cities. With an $8 billion asset book and ROA of more than 2 percent, India is Standard Chartered's third most profitable market, after Hong Kong and Singapore. An important element of Standard Chartered's success in India has been its highly successful acquisition of Grindlays Bank (from ANZ Bank) in 2001. The acquisition consolidated Standard Chartered's position, and its current premier status includes a strong presence in major cities and in nearly all product segments.

Foreign banks that have entered India more recently have focused on such niches as wholesale, investment, and private banking—and have done so profitably. Given the robust growth in India's financial-services industry, many of these institutions are now evaluating whether to venture into additional segments.

ICICI Bank, a top domestic private-sector bank, provides another example of how dramatic growth is possible in India. ICICI—using loan fairs, aggressive pricing, and direct sales for customer acquisition—has tripled its market share to more than 20 percent over the past four years and has secured its position as a leading mortgage lender. Indeed, with lower technology and factor costs, as well as lower profit aspirations, Indian private-sector banks have been able to take share away from both foreign and Indian public-sector banks. One element of their success has been their ability to structure their business models and operating platforms to suit the requirements of low breakeven levels in different products.

Seizing the Moment

International banks that have succeeded in India have a good deal in common, and institutions that aspire to enter the country can learn from their experiences. Most success stories indicate that potential entrants should

- evaluate profit pools to target where global presence, scale, and product expertise can provide competitive advantage over domestic players

- be flexible in striking a balance between localizing business models and operating platforms, and integrating them into global standards and platforms

- use Indian managerial talent—typically bright, highly educated, experienced in the local market, and widely available—to the fullest

- understand and inform the regulatory environment, and seize opportunities—both organic and inorganic—as they become available

Ultimately, forward-thinking international financial institutions need to explore strategies for banking in India. The country may not be a solution to the short-term global banking problem of slow growth, but it can be a significant medium-term opportunity that is relatively easily accessible at a reasonable level of risk.

Banks can begin to evaluate the India opportunity by asking themselves the following questions:

- Where are our current growth possibilities?

- What percentage of global incremental banking-revenue pools will originate in India in the short, medium, and long term?

- Which customer and product segments in India might be most attractive for our institution?

- What is our understanding of India's risks?

- Could the India opportunity be relevant for our bank?

- What are we risking by not evaluating the opportunity?

India is widely expected to become the third-largest economy in the world by 2035, behind China and the United States. Leading international banks will not be able to ignore it. Indeed, a stark choice may be looming: enter India now at relatively low cost, or enter later and pay heavily for the delay in terms of investment and lost opportunity.

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