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BANKING

27 July 2022

Takeaways from BOB Banking Conference: Digitisation is key

- **Imported inflation a concern but India still better placed than global peers; nominal GDP growth equals credit growth**
- **NBFCs/fintechs should complement banks; digitisation/tech adoption holds key to growth**
- **Evolution from banking access to usage and then financial health crucial, with women empowerment a key factor**

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Bank of Baroda's (BOB) 'Banking beyond Tomorrow' Conference 2022 saw insightful discussions by eminent experts on the banking architecture of the future, innovative technologies, new frontiers in financial inclusion & ESG finance. Key highlights:

India better placed but macro headwinds persist: RBI governor Shaktikanta Das, who inaugurated the conference, underscored concerns due to imported inflation (arising out of crude oil prices and currency depreciation), as India is a key importer of commodities. Although the currency has depreciated ~7% against the US dollar in CY22 YTD, it is still better placed than the Yen and Euro, among others. Moreover, the central bank can use its ample foreign reserves to deal with currency volatility. Separately, RBI expects banks to maintain capital buffers above mandated levels.

Nominal GDP growth of 12-13% plausible: Economists at the conference forecast nominal GDP growth of 12-13% (medium term) with real GDP growing 6-7% coupled with inflation of 5-6%. Banking credit growth should move in line with nominal GDP as infrastructure-related industries look for loans to bolster capacity utilisation. Further, for India to achieve its target of becoming a US$ 5tn economy by 2027, it will need a robust secondary bond market in contrast to the current low-volume market.

NBFC/fintech should complement banks; digitisation vital: Per expert panelists, new-age fintechs and NBFCs should provide innovative solutions, be asset-light and closer to the customer, thus complementing the banking sector rather than competing with it. Banks' collaboration with IT companies is important as technology is a key enabler. Digitisation has stabilised currency in circulation as a percentage of GDP and should be positive for the payments industry. UPI has seen mass adoption across India.

Financial health paramount: India's financial access is nearly saturated and the focus is now on usage which is seeing difficulties. About 53% of PMJDY accountholders are women and digital financial literacy is the next challenge to improve financial health.

ESG gaining traction. ESG-based green lending is being encouraged by banks and the renewables space offers ample opportunity for corporate lending. At the same time, banks should adopt an orchestrated approach.

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Key conference takeaways

Imported inflation a worry; India better placed

RBI governor Shaktikanta Das inaugurated BOB's Banking beyond Tomorrow Conference held on 22 Jul 2022 in Mumbai. Key highlights from his opening speech:

- **Imported inflation a worry:** Imported inflation (rising crude oil prices and currency depreciation) is a cause for concern. India is a key importer of commodities and the central bank is taking necessary steps to control inflation. Also, the RBI's inflation targeting framework has worked well since its adoption in 2016. The rupee has depreciated ~7% against the US dollar in CY22, but RBI maintained that it doesn't have any particular level of the rupee in mind. However, it can use foreign exchange reserves to deal with currency volatility.

- **India faring better than other major economies:** RBI maintained that spillovers from global monetary policy tightening due to elevated commodity prices, especially crude oil, as well as the lingering effects of the pandemic had combined to affect currencies worldwide. However, the rupee has fared better than many emerging and developed market currencies (for instance, the Japanese yen, euro, and British pound sterling) due to strong underlying fundamentals.

- **Unhedged forex exposure not a concern:** India has an external commercial borrowing (ECB) of US$ 180bn, of which 44% or USD$ 79bn remains unhedged. Of this, ~US$ 40bn are liabilities of public sector companies – mainly in the petroleum, railways and power sectors – which own assets that have a natural hedge. Also, being public sector entities, their foreign exchange risk could be absorbed by the government. The remaining US$ 39bn represents 22% of the total. This too includes borrowings of companies that have a natural hedge, i.e. earnings in foreign currencies. Thus, effectively a very small portion is truly unhedged.

- **Focus on good governance by banking security:** RBI urged banks to maintain key ratios such as capital buffers above the mandated levels as a sign of good governance. Moreover, banks are advised to strike a fine balance between digital and paper-based forms of communication. Although innovation is encouraged, there is an increasing need to address financial stability and cybersecurity at the macro level. Digital lending norms, which have been in the works for several months, are expected to come out shortly.

Nominal GDP growth equals credit growth

Takeaways from an Economists' Roundtable where Axis Bank, BOB and Citibank participated, among others:

- **Loan growth showing signs of improvement:** The corporate loan book has been gaining traction of late given better capacity utilisation. The retail book has also seen growth. Q1FY23 was one of the few quarters over the last couple of years when loan growth surpassed deposit growth.
- **Demand skewed towards infrastructure:** Industries related to the infrastructure sector, such as construction, cement and steel, are looking to raise capacity utilisation and thus to make enhanced investments. Larger companies in the cement and steel sectors are seeing traction, whereas smaller companies are not in a position to increase investments. Thus, demand is skewed and not uniform.
- **Investment-to-GDP ratio healthy:** If the investment-to-GDP ratio of last year at ~32% is maintained this year, it would be considered a good outcome.
- **Debt-based model driving India's growth:** About 60% of India's growth over the last 20 years has been contributed by consumption. This includes two distinct phases: Phase-1 over 2002-14 where consumption growth was supported by significant job and income growth. Phase-2 is the one being led by leverage which is reducing household savings and increasing household borrowings.

  For the next decade, if we want to follow the Phase-1 model, then growth should be revived by higher capex. This is because higher capex will positively affect jobs and income, in turn supporting consumption. The second leverage-based model can also lead to growth. This is because household debt-to-GDP which is ~40% at present can increase further, in line with global trends of countries living on higher debt.
- **Credit multiplier important:** Credit multiplier, which is defined as the total deposits created by the banking system as a multiple of the initial primary deposits, is very important as it will develop deposits/savings in the system.
- **Data analytics can spur MSME lending:** The use of digital infrastructure helps generate vast amounts of data that can be mined using data analytics to help provide credit to the MSME segment, which is the largest consumer (of small-ticket loans).
- **Bond markets still immature:** Development of bond markets is necessary for India to achieve its goal of a US$ 5tn economy by 2027. This is because infrastructure-related investment needs cannot be fulfilled by the banking sector alone. However, secondary bond market volumes remain low despite a comparatively better primary bond market.
- **Real GDP forecast at 6-7%:** Panel economists expect 6-7% real GDP growth coupled with 5-6% inflation in the medium term, implying nominal GDP growth of 12-13%. As a rule of thumb, banking sector credit growth is equal to nominal GDP growth (vs. 1.5x earlier).

Digital India and a digital financial system

Takeaways from a panel discussion on 'Banking Architecture in 2027' where Salesforce India and Edelweiss Group participated, among others:

- **Technology in banks crucial:** Banks' collaboration with IT companies is important as technology is a key enabler and functions as a backbone of the business. Technology is not proprietary as banks have access to various vendors. There are various ways in which a customer communicates with the bank and thus knowledge of customer is the value creator. The key for an organisation is how it adapts to the change and focuses on strengthening the business model. The focus should be on four aspects: (1) technology integration, (2) cybersecurity, (3) constant upgrades in terms of people skills and customer awareness, and (4) innovation.

- **Credit penetration must improve:** The Indian banking system has one of the lowest cost-to-income ratios in the world, but efficiency must be measured not only in terms of financials but also by way of (1) meeting credit needs of the society, (2) the degree of financial services provided, and (3) the cost at which we are able to provide these. Credit penetration is only 55% of GDP and hence the system carries significant inefficiencies. Also, only 75% of credit requirements are met by the formal system.

- **NBFCs to complement banks:** Credit and banking used to be synonymous. However, over the last 15 years, credit has become hybrid and diversified with the emergence of NBFCs, HFCs, etc. Banks will remain central to credit due to their access to a customer's savings. On the other hand, NBFCs should provide innovative solutions, be asset-light and closer to the customer, thus complementing the banking sector rather than competing with it. The focus should be on addressing customer needs – already, the financial sector is changing from being product-centric to a solution provider.

  Credit also requires equity. For every Rs 100 lent, Rs 10-15 of equity is needed. The equity of the entire financial system totals Rs 18tn-19tn, with 25-30% coming from NBFCs, including HFCs.

- **Real interest rates matter:** Irrespective of the interest rates charged on loans, real interest rates matter significantly to customers. When real interest rates are positive, investment in financial assets increases. If real rates are negative, the investments go into physical assets such as real estate.

- **Immense opportunities in infrastructure sector:** Capacity building in the infrastructure sector has led to a change in the mindset of bankers. For instance, a greenfield road project bid with certain traffic assumptions would be looked at differently now versus 15 years ago. Green infrastructure projects generate alphas greater than the curve given the focus on net-zero carbon emissions in the future.

- **Payments industry to grow over three-fold:** The Indian payments industry turnover is expected to more than triple from US$ 3tn in 2021 to US$ 10tn by 2026. This implies technology is vital and the business carries vast opportunity.

- **Fintech are solution providers, not banks:** Only regulated entities should provide credit so that leverage can be controlled in the system. Many fintechs came with a BNPL (buy now, pay later) model that they christened as 'deferred payment' but which was red flagged by the regulator. Business models should revolve around customer satisfaction – for instance, fintechs must specify if the loan is being provided by a bank or NBFC. Also, banks will play an important role in funding fintechs.

- **Currency in circulation (CIC) stabilises:** CIC should not be viewed in absolute terms but as a percentage of GDP – this metric is stabilising due to digitisation. GST and UPI are major drivers behind the reduction in cash usage and formalisation of the economy. The pandemic was also instrumental in encouraging the greater use of digital transactions.

New models for digital banking

Takeaways from a panel discussion on 'Innovative Technologies and New Business Models' where Mann Deshi Bank and Zest Money participated, among others:

- **Leveraging open banking:** PSU banks can use open banking to leverage fintechs – not just leveraging the balance sheet but also providing a host of value-added services to corporate customers such as cash flow forecasts and treasury management tools.

- **Stability from banks, tech prowess from fintechs:** Fintechs were initially expected to be more efficient, leaner and more agile than banks. However, banks will always bring the stability and fintechs the technology efficiency. The solution for the customer will be in a melding of the two. End-to-end digital servicing is the key and banks are ready to collaborate with the digital ecosystem. Moreover, empowering customers would result in a UPI kind of revolution.

- **Covid proved efficacy of AI-based models:** Over time, AI-based models have learnt faster and proved to be more accurate than human judgement. Covid was a good testing ground for this.

- **New innovative models needed:** Over 75,000 weekly markets for food, agri-commodities and other tradable goods exist in India. Their business model is based on daily earnings (borrow in the morning and repay in the evening) and thus participants visit moneylenders for loan demands despite holding savings accounts in a bank. Also, the paperwork load is heavy for a bank loan. Thus, banks must tailor agile, innovative products based on client cash flow needs.

- **Regulatory headwinds a myth:** Several fintech business models in the West were unsustainable and non-inclusive as they were developed by venture capitalists without keeping the end customer in mind. In India, RBI intends to come out with a guideline-based regime for fintechs, learning from the global debacles.

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Focus on UPI and other payment modes

Takeaways from the keynote address by National Payments Corporation of India (NPCI):

- **Rural digital adoption key:** The government is promoting digital transactions, as evident from cash transfers being replaced by direct benefit transfers, thus promoting formalisation of the economy. Digital adoption among the rural population is gaining traction and will be instrumental in future growth of the payments industry. (Our initiation report on **SBI Cards** discusses this topic in detail.)

- **Wide array of options:** The focus of the RBI and NPCI is on UPI and on the use of other digital channels, with a thrust on making the processes in smaller transactions more efficient. Customers now have an array of options such as UPI, credit cards, debit cards and wallets. Further, the Rupay credit card on UPI is expected to become operational within two months in order to expand the bouquet of services.

- **Banking share in payments can increase:** The market share of banks in the payments space is between 5% and 30%. Banks can work on offering a seamless experience as their top 200mn-250mn customers have more than one bank account and need to manage these accounts at one place – something which is currently handled efficiently by non-banks.

- **UPI has substantial scope in equity markets:** The use of UPI in applying for IPOs (50% of applicants) has been very successful. However, penetration can rise substantially in terms of usage for the day-to-day functioning of equity markets.

- **Fraud levels low:** Fraud remains low as compared to international levels but is being watched closely by RBI and NPCI. A variety of aspects need to be developed, such as a central depository, to further minimise fraud.

- **CIC:** CIC as a percentage of GDP should be targeted in single digits or close to it.

Financial inclusion

Takeaways from a panel discussion on 'New Frontiers in Financial Inclusion' where MicroSave Consulting and Kaleidofin, among others, participated:

- **Improvement in financial inclusion index:** India has moved from 43.4 on the financial inclusion index in 2017 to 53.9 in 2021 which is positive. This index has been constructed using 97 different sub-parameters which quantifies the extent of financial inclusion.

- **Catering to the two Indias:** There are two ecosystems in the country – one is Bharat and the second is India. Both need to be viewed through a different lens when it comes to financial health. Bharat is largely catered to by PSU banks which have done remarkably well in terms of access. Having the right use cases (transferring money between self-help groups is still not allowed) will be instrumental to improve quality of service. India has large players and partnerships coming up (e.g. fintech, co-lending). To bridge the gap between Bharat and India, we must combine the power of technology and data science with assistance and touch. Account aggregators could be more powerful as they have access to aggregated customer data.

- **Defining financial health:** Financial health is defined as meeting current needs, absorbing financial shocks and pursuing financial goals. It has four components: spend, save, borrow and plan.
- **Need for women empowerment:** The financial health of women can be gauged by the material aspect – ability to build assets, access to credit, and access to knowledge and skills to take the right decision. Women empowerment should also be looked at from the business correspondent (BC) viewpoint, and smooth communication between the BC and banks should be encouraged.
- **Financial access to usage to health should remain key priority:** Financial access in India has reached near-saturation levels, graduating from one bank account per household to one account per person over 18 years of age. This began with the Pradhan Mantri Jan Dhan Yojana (PMJDY) in 2014. Usage, however, is a challenge. About 53% of the accountholders are women and digital financial literacy is an uphill task.
- **Customer protection weak:** Customer protection and grievance redressal is fairly weak and a lot needs to be done. More investments are required on all fronts to help build financial health.

ESG paramount in today's era

Takeaways from a panel discussion on 'ESG Finance and Tackling Climate Change' where ECube Investment Advisors and NSE, among others, participated:

- **ESG the norm:** On the policy front, all organisations have an ESG (environmental, social, governance) policy. Whereas the gap on meeting governance requirements is low, that on complying with environmental and social aspects is still relatively high.
- **Win-win proposition:** Forward looking organisations have already started the ESG drive. However, it is not a competition as we either win or lose together because a sustainable business cannot operate in an unsustainable environment.
- **Environmental and social aspects still to be ironed out:** The stewardship policy is defined in India. Asset managers understand governance well as they have seen related organisational failures. For the environmental and social aspects, asset managers are circling on how to address the issues and the tangible long-term risks arising out of them. Over a period of time, the asset management industry will evolve and involve ESG-led companies in a tangible manner in decision making.
- **Banks must do more:** The banking sector has considered green lending, but adoption is currently piecemeal and in need of an orchestrated approach. Corporate banking currently has high exposure to heavy emission industries such as power, oil & gas and metals, which needs to come down gradually.

As per an India Energy report published by the Power ministry, the funding requirement for climate change transition is US$ 1tn by 2030, of which renewables form a large chunk. Thus, there is substantial opportunity for banks and other financial institutions. There is also the retail and MSME green lending space (electric vehicles, green buildings, waste management, consumer durables), where the opportunity over the next five years is pegged at Rs 7tn-8tn. Of this, the EV opportunity over the next 12 months alone would be worth Rs 300bn and MSME Rs 200bn.

- **Skill development vital:** Skill development is a new area. People handling the ESG proposals at banks need to have a thorough understanding of ESG ratings, concepts and certifications. For instance, Singapore has made it mandatory to have 12-14 technical skills (certification) for people handling projects related to sustainable financing.

- **NSE Prime a positive badge:** NSE Prime is a unique framework that prescribes a higher standard of corporate governance as compared to the regulations required, with additional disclosure requirements. However, applications are not yet being accepted as the groundwork is underway. It is heartening to note that smaller sized MSME intend to be a part of Prime, as illustrated by enquiries. NSE Prime is considered by many as a positive badge that increases visibility to good quality investors.

- **Greenwashing not yet a concern:** Greenwashing cannot be denied in India, but the degree to which it is occurring is not yet alarming as companies are more focused on becoming ESG-friendly rather than on greenwashing.

- **Green projects have shorter payback periods:** Typically, energy efficiency projects have a payback period of 2-3 years and many even less than 2 years. There are many opportunities available with higher ROI.

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