AFTER THE DUST SETTLES
OPPORTUNITIES FOR INDIAN BANKS IN THE POST-DEMONETISATION WORLD
EXECUTIVE SUMMARY

In November 2016, the Indian Prime Minister unleashed what has been heralded as one of the biggest reforms of the Indian economic history – the act of demonetizing currency worth INR15 TN (US$~200 BN). Since the policy action, the nation has showcased a wide range of responses – ranging from frustration and chaos to strong sentiment of hope that the action would lead to a better life for the common man, from applauding the government to taking such a bold step to writing off the impact of the action as temporary.

In the days after the announcement, bank branches and ATMs became symbolic of the ‘pulse’ of the public reaction. The banking industry also came into focus as the primary platform for execution of the policy. It seems that Indian banks have successfully implemented the mammoth task of replacement of old notes. However, the operational complexities may have taken away attention from the opportunities that banks can realise in a post-demonetised world.

In this special joint report by Oliver Wyman and Ambit Capital, we take stock of the impact of demonetisation on the banking sector. Our study shows that there have been clear winners in the banking sector over the last few months. While the jury is still out on sustainability of impact that demonetisation has created, we believe it is important to recognise some critical trends that will influence the strategies of financial services players in the coming quarters – i) Excess liquidity in banks, ii) Slowdown in consumption resulting in slower credit demand, iii) Asset value deterioration esp. in real estate and, iv) Faster take up of digital payments.

We believe that the agenda outlined for Indian banks in Oliver Wyman’s report “Indian banks: tacking into the wind” has only been accelerated, with demonetisation acting as a catalyst. It has also necessitated that banks undertake significant further steps to retain and improve their competitive positioning under the evolving business environment, namely:

1. Shift strategic focus onto liabilities
2. Build advisory platform for masses to capture the shift in asset allocation
3. Adopt ‘digital finance’ as the mechanism to achieve financial inclusion
4. Leverage the wealth of data being created for business decisions and risk management
5. Scout for opportunities for cost reduction due to decrease in cash usage

Demonetisation may cause near-term pain to banks, as they face unexpected balance sheet challenges in the near term. However, winners in this environment will be differentiated by the pace of implementing strategic, transformative initiatives in order to position themselves favourably for the winds of change sweeping through the industry.
1. TAKING STOCK OF THE IMMEDIATE, FLEETING IMPACTS OF DEMONETISATION

On 8th November 2016, Prime Minister Narendra Modi unleashed one of the biggest reforms of Indian economic history – high value currency notes to the tune of INR15 TN (~US$200 BN) were being withdrawn from circulation. It has been more than three months now since the measure was implemented. Since the policy action, the nation has showcased a wide range of responses – ranging from frustration and chaos to strong sentiment of hope that the action would lead to a better life for the common man, from applauding the government to taking such a bold step to writing off the impact of the action as temporary.

In the days after the announcement, bank branches and ATMs became symbolic of the ‘pulse’ of the public reaction. The banking industry also came into focus as the primary platform for execution of the policy. As the final numbers on demonetisation emerge, it is clear that bank branches managed to successfully implement the large scale operational challenge posed by the policy action.

Exhibit 1: 97% of demonetised money was deposited in banks and ~60% of it has already been remonetised

Note: US$ = 67.7 INR
Source: RBI Press Release
The demonetisation drive led to sharp changes in a number of indicators related to financial services across various types of products and players. Our report focuses on the dominant drivers of banking business i.e. deposits and loan book.

1.1. DEPOSITS

Banks have witnessed an unprecedented surge in deposits post demonetisation. Net increase in deposits for banks between 28th October and 23rd December was INR5.23 TN which was almost 2X of deposits received during previous six months of the financial year. As a result, YoY deposit growth had spiked to 14.5%, in mid-Dec’16, vs. average ~10% YoY growth before demonetisation – almost 50% increase in the growth rate.

Deposits in no-frills accounts (Jan-Dhan accounts) have increased by 56% post demonetisation from INR456 TN to INR710 TN with average balance per account increasing from INR2,330 to INR3,570. However, the demonetisation move did not significantly attract previously unbanked customers to open new accounts (only seven million new no-frills accounts opened on a base of ~300 million no-frills accounts). The implication of the action has been that it may lead to a more ‘active’ customer base for banks in the future.

There has been a stark difference in the performance of banks in garnering deposits during the demonetisation drive. Banks that had a larger physical footprint (branch network, ATMs), e.g. State Bank of India, HDFC Bank, Punjab National Bank, gained a disproportionate share of deposits compared to others and they now have an advantage in their funding profile. There have been notable performances from the likes of IndusInd Bank, IDBI Bank and Kotak Bank.

**Exhibit 2: The YoY growth in deposits in the banking sectors Dec’16 has increased by 50%**

<table>
<thead>
<tr>
<th>BANKING Y-O-Y CREDIT GROWTH</th>
<th>POST-DEMONETIZATION IMPACT ON SELECT METRICS</th>
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<tbody>
<tr>
<td></td>
<td>CASA</td>
</tr>
<tr>
<td></td>
<td>• 36x increase in QoQ growth rate</td>
</tr>
<tr>
<td></td>
<td>• 27% average CASA in 2Q17 vs. 30% in 3Q17</td>
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<tr>
<td></td>
<td>Deposits</td>
</tr>
<tr>
<td></td>
<td>• 24x increase in monthly growth rate in deposits</td>
</tr>
<tr>
<td></td>
<td>• INR89.5 TN in 2Q17 vs. INR3.8 TN in 3Q17</td>
</tr>
<tr>
<td></td>
<td>• 5.1% increase in total assets</td>
</tr>
<tr>
<td></td>
<td>• INR112.3 TN in 2Q17 vs. INR118.1 TN in 3Q17</td>
</tr>
<tr>
<td></td>
<td>JanDhan Account</td>
</tr>
<tr>
<td></td>
<td>• 7 million new JanDhan accounts between 9 Nov’16 and 28 Dec’16</td>
</tr>
<tr>
<td></td>
<td>• ~3% increase in the account number</td>
</tr>
<tr>
<td></td>
<td>• 53% increase in average balance during the</td>
</tr>
<tr>
<td></td>
<td>same period</td>
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<tr>
<td></td>
<td>• INR 2331 as on 9 Nov’16 vs. INR 3573 as on</td>
</tr>
<tr>
<td></td>
<td>28 Dec’16</td>
</tr>
</tbody>
</table>

Source: RBI database
Exhibit 3: Branch share (as opposed to share of deposits pre demonetisation), may be a lead indicator of which banks may gain a disproportionate share of the excess liquidity (selective banks)

GROWTH IN DEPOSIT MARKET SHARE*¹
(FY17 – 3Q VS. FY17 – 2Q)

*¹ Deposit Market share = Bank deposit / Total deposit across 31 banks

Note: Growth in deposit market share = [(Deposit market share in FY17-3Q/Deposit market share in FY17-2Q) - 1]. Banks consists of HDFC, ICICI, Axis, Kotak, IndusInd, Yes, DGB, SBI, BoB, PNB, Bol, UBI, Canara, Oriental Bank of Commerce, CBI, IDBI Bank, Indin Bank, Syndicate Bank, UCO Bank, Indian Overseas Bank, Corporation Bank, Andhra Bank, Bank of Maharashtra, Vijaya Bank, Dena Bank, United Bank of India, Federal Bank, Karur Vysya Bank, City Union Bank, South Indian Bank, J&K Bank

Source: RBI database, Bank quarterly filings
1.2. LENDING

The outstanding loan book of Indian banks has contracted by ~INR640 BN (~1% of the loan book) to INR73.4 TN between Oct’16 and Dec’16. H2 generally sees a growth in credit and while post-demonetisation YoY loan growth for banks have fallen to 4.7% vs. ~10% in the previous years. Research indicates that number of credit bureau inquiries has dropped by more than 20% since demonetisation.

Exhibit 4: The YoY credit growth has fallen to 4.7% and credit bureau enquiries has dropped by ~25%

The slower pace of new credit issuance is also evident based on credit bureau enquiries. Preliminary data from credit bureau suggests that enquiries for new loans have seen a ~20% decline post demonetisation. It is plausible that the decline in bureau enquiries may be temporary as i) sudden disruption in business for the demand based economy and ii) temporary deployment of banking resources to address demonetisation process leading to shift of focus away from lending.

Despite overall slowdown in credit uptake, some banks have stood out in their ability to grow the book and with additional deposits in the system and anticipated rate cuts, lending should increase although at a slower pace in the short term.
CONCLUSION

While the period of implementing the currency exchange was a high intensity period with the Indian banking sector experiencing historical peaks on a number of indicators, we believe that there have been clear winners amongst banks. The winners have managed to garner larger share of deposits and also manage to show relatively better growth in assets.
2. KEY TRENDS THAT WILL DRIVE MEDIUM TERM IMPACT ON FS PLAYERS

A number of broader economic trends will be key determinants of the impact on FS players in the medium- to long-term. While the jury is still out on the sustainability of these trends, we highlight four key trends that will influence strategies of Indian banks:

I. EXCESS LIQUIDITY IN BANKS

Demonetisation has led to a surge in deposits for banks simultaneously reducing their loan books. Between 28th October to 23rd December 2016, banks saw net deposit inflows of INR5.3 TN whilst outstanding loans decreased by INR640 BN. This led to various banks cutting their deposits rates in the range of 25-100bps (with SBI slashing bulk deposit rates by up to 1.9%) followed by aggressive lending rate cuts (90bps cut in MCLR by SBI).

Despite the lower funding costs due to the excess liquidity and extent of remonetisation, the credit demand remains the dominant driver of the NIMs of the banking sector and will continue to drive profitability.

Exhibit 6: We estimate that depending on the extent of remonetisation*1 and the growth in loan book, the NIM impact on banks could vary between 15bps-35bps

<table>
<thead>
<tr>
<th>LOAN GROWTH/RATE OF REMONETISATION</th>
<th>30%</th>
<th>50%</th>
<th>70%</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>-0.329%</td>
<td>-0.328%</td>
<td>-0.327%</td>
</tr>
<tr>
<td>10%</td>
<td>-0.248%</td>
<td>-0.246%</td>
<td>-0.244%</td>
</tr>
<tr>
<td>15%</td>
<td>-0.167%</td>
<td>-0.164%</td>
<td>-0.161%</td>
</tr>
</tbody>
</table>

*1 Remonetisation = How much of the excess liquidity flows out of the banking system
*2 Note: The loan growth and remonetisation scenarios are taken for one year (Dec-16 to Dec-17)

II. SLOWDOWN IN CONSUMPTION RESULTING IN SLOWER CREDIT DEMAND

Historically, there has been a strong correlation between GDP growth and credit growth in India with credit growth to nominal GDP growth ratio (multiplier) being at ~1x. The multiplier generally expands during the high GDP periods but contracts during low GDP growth period. Hence, the multiplier which had increased to 2.2x during high GDP phase of FY05-07 has come down to ~1x during the low GDP growth period of FY14-16 due to weak private capex. With GDP growth expected to remain weak we expect loan book of Indian banks to grow at ~7% CAGR between FY16-18.
III. ASSET VALUE DETERIORATION ESP. IN REAL ESTATE

Indian banks and NBFCs have a large exposure to physical assets (such as real estate) as collateral. For example, Indian banks’ exposure to real estate based sectors is ~15% of the loan book. Our analysis suggests that in an adverse scenario of ~30% reduction in real estate prices, ~20% of the loan book with exposure to real estate will see LTV crossing 100% thereby putting the book at risk of default.

Exhibit 7: We estimate that an additional ~3-5% of the loan book may be at a risk of default due to fall in real estate prices in the near-medium term

<table>
<thead>
<tr>
<th>DECLINE IN ASSET PRICES</th>
<th>INCREMENTAL PORTFOLIO AT RISK IN DIFFERENT POST DEMONETIZATION SCENARIOS</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>5%</td>
<td>10%</td>
</tr>
<tr>
<td>10%</td>
<td>20%</td>
</tr>
<tr>
<td>15%</td>
<td>30%</td>
</tr>
</tbody>
</table>

Source: Oliver Wyman analysis

IV. TAKE UP OF DIGITAL TRANSACTIONS

Demonetisation has had a positive impact on uptake of digital transactions – data from the Reserve Bank’s electronic payment system indicators shows an increase across payment types. However, as the cash comes back into the system, there is going to be a pressure on digital modes – something that was already witnessed in January 2017. With Government actively promoting the adoption of digital payments through apps like BHIM, next few quarters will be important to see adoption and sustainability of digital transactions.

CONCLUSION

While the jury is still out on sustainability of impact that demonetisation has created, we believe it is important for banks to recognise the critical trends to define their mid- to long-term strategies.
3. NEW OPPORTUNITIES TO IMPROVE COMPETITIVE POSITIONING

Based on the Oliver Wyman and Ambit Capital teams’ reflection on the trends, we believe that the demonetisation action has not altered the fundamental challenges to be addressed by Indian banks. We reiterate the key strategic agenda items from Oliver Wyman’s report “Indian Banks: Tacking into the wind”. These agenda items are across the themes of – fixing the fundamentals, reinventing business models and not ignoring the softer aspects.

Exhibit 8: Call for action for banks – “Indian banks – tacking into the wind”

<table>
<thead>
<tr>
<th>THEME</th>
<th>AGENDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fix the fundamentals</td>
<td>Agenda 1: Enhance transparency</td>
</tr>
<tr>
<td></td>
<td>Agenda 2: Risk and capital management: Drive a broad-based transformation in risk and capital management capabilities</td>
</tr>
<tr>
<td></td>
<td>Agenda 3: Credit management: Plug the gaps and clear the muck in credit management</td>
</tr>
<tr>
<td>Reinvent business models</td>
<td>Agenda 4: SME 2.0: Push the Final Frontier</td>
</tr>
<tr>
<td></td>
<td>Agenda 5: Retail banking: Embrace digital technology and develop propositions for affordable banking</td>
</tr>
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<td></td>
<td>Agenda 6: Corporate banking: Corporate banking: Push new frontiers to drive excellence in execution</td>
</tr>
<tr>
<td>Don’t ignore softer aspects</td>
<td>Agenda 7: Address key human resource challenges</td>
</tr>
<tr>
<td></td>
<td>Agenda 8: Strengthen governance, compliance and culture</td>
</tr>
</tbody>
</table>

Source: Oliver Wyman’s publication “Indian banks: tacking into the wind”, December 2016

From the media reports and our private conversations with banks, we realise that leaving aside some industry leaders, majority of the banks have already started treating demonetisation as an event of the past with no major implications on their future strategies. This response is largely led by a belief that most of the impact of the action was ‘temporary’. We challenge this view and believe it is important to identify the undercurrents that the action has unleashed as well as recognise that there is a definite push by the government to ensure sustained impact (e.g. lowering of transaction charges, introduction of payment apps like BHIM, big data initiatives of the IT department). We believe that there is a significant opportunity for banks to retain and improve their competitive positioning under the evolving business environment. We highlight five specific strategic initiatives that banks can take in the near term:

1. Shift strategic focus onto liabilities
2. Build advisory platform for masses to capture the shift in asset allocation
3. Adopt ‘digital finance’ as the mechanism to achieve financial inclusion
4. Leverage the wealth of data being created for business decisions and risk management
5. Scout for opportunities for cost reduction due to decrease in cash usage
3.1. **SHIFT STRATEGIC FOCUS TO LIABILITIES**

Indian banks have traditionally viewed assets as the key driver of business and deposits as an enabler of building asset book, which come with SLR requirements. Only a few banks consider deposits as a source of value by themselves. Notable exception has been the payments space which is seen as a source of ‘float’. While demonetisation hasn’t changed the outlook of banks in the long term, the tools needed to make the most of the short term disruption should, in principle, be useful in changing the approach of banks to managing liabilities.

In the near term, banks need to ask a few important questions, as they think about their liabilities strategy:

1. How transient will these new deposits be?
2. What is the value of retaining these deposits?
3. How can the deposits be retained?
4. What is the relative benefit of steering these into CASA vs. FDs and investment products?
5. How can we deploy our excess liquidity e.g. into short-term non relationship assets, term lending?

In the long term, these questions are largely relevant – the first one becomes more about stability of any deposits which can be volatile (beyond the classic core vs. volatile), and five is about managing any short term burst in deposits.

Now is the time for Indian banks to implement best practice liability management framework that aligns the organisation to generating the target liability profile and includes:

1. Economic value of deposits – what is the total economic value of deposits including liquidity costs, customer value analysis?
2. Improved FTP framework – how to measure the value of deposit business? What should be the pricing governance framework?
3. Deposit analytics – what is a good deposit to retain?
4. Structured processes around pricing and performance measurements – how to design products to build the strategic liabilities profile?
3.2. BUILD ADVISORY PLATFORM FOR MASSES TO CAPTURE THE SHIFT IN ASSET ALLOCATION

We believe that lower interest rate on deposits coupled with behavioral shift away from physical assets like real estate and gold will give an impetus to other forms of investments e.g. equity, mutual funds, life insurance which traditionally have seen low retail participation in India.

There is significant opportunity for banks to move beyond “deposit-led” liabilities products to advisory business. In a market such as India, we believe that data tools such as robo-advisory will be the way forward to deliver advisory services to the large masses. Robo-advisors have potential to commoditise all steps of the advisory value chain i.e. investment planning, execution and feedback.

US and European markets have already seen the emergence of new attackers and established players adopt various forms of robo models, although the proportion of AUM managed under these models is still very small. Emerging next-generation models are likely to combine robo base with advisor overlay e.g. simple product range for low cost solution for mass affluent.

Exhibit 9: Robo advice propositions continue to evolve and are rapidly offering holistic services

- One click information on customer holdings for better portfolio allocations
- Portfolio replication – active to passive and vice versa
- Bionic/human interactions at key points in customer journey – either as guidance or advice
- Open data environment and unique digital ID
- Aggregated customer information to be made available to create a more optimised and bespoke customer solution
- Commoditisation of portfolio management
- Investment education; Planning tools & calculators
- Objectives based investments (time based, risk based, motive/themes based, social investing etc.)
- Enhanced product set (e.g. Separate accounts, options)

For banks, a Robo 2.0 proposition brings with it some core benefits e.g. better control over advice and guidance process, increased transparency over a consumer’s existing investments and financial situation allowing for more tailored solutions, better product comparison and more targeted offering and finally, reduced reliance on less favorable forms of investment (i.e. term deposits accounts, overly complicated/risky products). These tools will be highly beneficial in widely distributed markets like India.
3.3. ADOPT ‘DIGITAL FINANCE’ AS THE MECHANISM TO ACHIEVE FINANCIAL INCLUSION

Digital enablement has the potential to revolutionise offerings for the unbanked and underbanked. The decline of cash transactions and the pooling of assets in banks open up possibilities for a range of new technologies, including mobile platforms to extend access in rural areas and digital wallets to streamline savings and payments.

In Oliver Wyman’s recent report “Accelerating financial inclusion in Southeast Asia”, we highlight five areas where digital provides opportunities for increasing financial inclusion:

1. Digitally enabled customer identification and verification: Beyond the Aadhaar, a 12-digit unique national ID which supports the country’s real-time verification infrastructure, enhanced digital information can be developed for lower-cost and even faster customer identification. For example, biometrics data can be collected at account opening to facilitate future banking services, such as easy KYC and payments authorisations.

2. Scalable delivery by tackling last-mile distribution: Digital enablement could lower distribution and servicing costs to enable widespread, lost-cost points of access, for example, through mobile money or point-of-sale devices.

3. End-to-end digitisation in the flow, access, and infrastructure of retail payments: End-to-end digitisation of the payments value chain and ecosystem – beginning with digital G2P payments and extending to P2All payments, use of open APIs and interoperable networks – can greatly reduce money transfer fees.

4. Credit and fraud risk reduction via digitally-enabled data capture and analytics: Alternative data sources enabled by digital, such as payments and telecoms data, combined with analytics provides rich foundation for enhanced customer profiling, risk assessment, and fraud prevention that enable extension of credit to customers underbanked.

5. Cost-effective mobilisation of low-cost deposits through a digital access: Digital technology has the potential to disrupt the savings value chain by offering savings products to extended segments via mobile platforms, enabling innovative and customised products such as goal-based savings plans, and providing additional outlets to agents for cash-in and cash-out.

3.4. LEVERAGE THE WEALTH OF DATA BEING CREATED FOR BUSINESS DECISIONS AND RISK MANAGEMENT

So far, the average Indian bank has paid limited attention to data for making business and risk decisions – especially in the SME and the underbanked segments. Demonetisation is prompting these segments to migrate to digital payments. As the digital payments grow, it will create a larger trail of customer information which in turn will be a “data dividend” for the institutions.

Banks must act now, more than ever, to upgrade their data analytics capabilities to leverage this data for better underwriting decisions, effective upselling and cross-selling, improved risk management capabilities e.g. through automated early warning signals.
3.5. SCOUT FOR OPPORTUNITIES FOR COST REDUCTION DUE TO DECREASE IN CASH USAGE

According to an HBR study (The Cost of Cash in India), The Reserve Bank of India and commercial banks spend a total of INR210 BN (US$3.5 BN) on currency operations annually. The HBR study highlights that the ratio of money held in bills and coins (M0) to the amount held in demand deposit and savings accounts (M2) in India is 51%, which is higher than Egypt (29.3%), South Africa (8.9%), and Mexico (8.7%). Moreover, considering just currency, the ratio of currency to GDP in India (12.2%) is higher than countries such as Russia (11.9%), Brazil (4.1%), and Mexico (5.7%).

Oliver Wyman and Ambit Capital estimates suggest that out of the total operating expenses of banks of INR~2,243 BN, ~70% of the expenses are linked to the physical channels of branches and ATMs. This offers a tremendous room for optimisation of operating expenses, should the decline in cash usage be sustained. As an example, cash management costs (related to ATM and branch cash pick-up/refilling) are directly linked to cash usage and can be optimised with immediate effect. On a medium term basis, it may be worthwhile to revisit the design of the network of branches and ATMs (for example # of outlets, location strategies) to align to the reduction in cash usage.

CONCLUSION
Demonetisation has accelerated the agenda outlined for Indian banks in Oliver Wyman’s report “Indian banks: tackling into the wind.” It has also necessitated that banks’ undertake significant further steps in the areas of liabilities management, advisory services and analytics to retain and improve their competitive positioning under the evolving business environment. While demonetisation may cause near-term pain to banks, winners in this environment will be differentiated by the pace of implementing strategic, transformative initiatives in order to position themselves favourably for the winds of change sweeping through the industry.
ADDITIONAL READING

OLIVER WYMAN

Indian banks: tacking into the wind
December 2016

Managing Complexity: The State Of The Financial Services Industry
February 2015

The State of the Financial Services Industry 2017: Transforming for Future Value
January 2017

Winning In The Era Of Liquidity: Turning Deposit Management Into Competitive Advantage
October 2015

Modular Financial Services: The New Shape Of The Industry
January 2016

Reimagining Financial Inclusion
November 2015

The Digital Disruption Battlefield Winning In A Time Of Change
June 2015

Accelerating Financial Inclusion in South-East Asia with Digital Finance
2017

The FinTech 2.0 Paper: Rebooting financial services
June 2015
M+R+T resets to the fore

Into uncharted territory

An economic hammering is a given

...And we all fall down
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