BCG
THE BOSTON CONSULTING GROUP

FICCI
FEDERATION OF INDIAN CHAMBERS OF COMMERCE AND INDUSTRY

Indian Banks' Association

Indian Banking 2020

Making the Decade's Promise Come True

The Boston Consulting Group (BCG) is a global management consulting firm and the world's leading advisor on business strategy. We partner with clients in all sectors and regions to identify their highest–value opportunities, address their most critical challenges, and transform their businesses. Our customized approach combines deep insight into the dynamics of companies and markets with close collaboration at all levels of the client organization. This ensures that our clients achieve sustainable competitive advantage, build more capable organizations, and secure lasting results. Founded in 1963, BCG is a private company with 70 offices in 41 countries. For more information, please visit www.bcg.com.

Federation of Indian Chambers of Commerce and Industry (FICCI) is India's apex chamber representing over 500 industry associations and over 2,50,000 business units — small, medium and large — employing around 20 million people. FICCI works closely with Central and state governments and regulatory bodies for policy change.

Indian Banks' Association (IBA) is the premier service organization of the banking industry in India. Its members comprises of almost all the Public, Private, Urban co–operative and Foreign banks having offices in India, developmental financial institutions, federations, merchant banks, housing finance corporations, asset reconstruction companies and other financial institutions.

BCG
THE BOSTON CONSULTING GROUP

FICCI
FEDERATION OF INDIA CHAMBERS OF COMMERCE AND INDUSTRY

Indian Banks' Association

Indian Banking 2020

Making the Decade's Promise Come True

Alpesh Shah

Ashish Garg

Bharat Poddar

Neeraj Aggarwal

Pranay Mehrotra

Ruchin Goyal

Saurabh Tripathi

September 2010

bcg.com

© The Boston Consulting Group, Inc. 2010. All rights reserved.

For information or permission to reprint:

Please contact BCG at:
E–mail: bcg–info@bcg.com
Fax: +91 22 6749 7001, attention BCG/Permissions
Mail: BCG/Permissions
The Boston Consulting Group (India) Private Limited
Nariman Bhavan
14th Floor
Nariman Point
Mumbai 400 021
India

Please contact FICCI at:
E–mail: finance@ficci.com • Website: www.ficci–banking.com
Fax: +91 11 23320714 – 23721504, attention FICCI/Permissions
Tel: +91 11 23738760–70
Mail: Federation of Indian Chambers of Commerce & Industry
Federation House
1, Tansen Marg
New Delhi – 110 001
India

Please contact IBA at:
E–mail: rema@iba.org.in • Website: www.iba.org.in
Fax: +91 22 22184222, attention IBA/Permissions
Tel: +91 22 22174012
Mail: Indian banks' Association
Corporate Communications, Centre 1
6th Floor, World Trade Center,
Cuffe Parade
Mumbai – 400 005
India

Contents

Executive Summary 4

Indian Banking 2020: Opportunities and Challenges 6

Ten Major Trends that will Shape the Indian Banking Industry

Two Challenges of the Decade

Bankers' Expectations Vary

Crucial Role for NBFC and DFI

Financial Inclusion: Rising up to the Nation's Expectations 17

Learnings from What Works — Collating Pieces of the Puzzle

A Business Model from a Clean Slate

Ring–fence Financial Inclusion — Two Approaches for Banks

Restoring the People Advantage in the Public Sector 23

Unique Complexities in the Public Sector

A Balanced Intervention — Discipline Levers

- Steady Talent Induction
- Sensitive Performance Management System
- Systematic Succession Planning and Career Management
- Structural Adjustments in Employee Costs

A Balanced Intervention — Motivation Levers

- Empower the Second Layer
- Stimulate Non Officer Cadres
- Create a "Virtual University" for Skill–set Development
- Structured Change Management

Imperatives for the Government and Regulations 37

Deepen Wholesale Debt Market with Top Priority

Enhance Economic Viability of Financial Inclusion

Continued Emphasis to Revitalize Rural Co–operative Banking Institutions

Enable NABARD to Play Pivotal Role in Rural Infrastructure Development

Spur HR Transformation in Public Sector Banks

Executive Summary

The optimism about Indian economic growth portends well for Indian banks. There are, however, challenges in retaining profitability and growth in the next decade. The industry has to live up to high expectations from several quarters. This report highlights ten major trends that will shape Indian banking over next decade. It identifies two critical and complex challenges thrown at the industry for which solution has to be found with urgency. The report outlines potential solutions and articulates key imperatives for government and regulation. The ten major trends to watch out for are:

1. Retail banking will be immensely benefited from the Indian demographic dividend. Mortgages to grow fast and will cross Rs 40 trillion by 2020.
2. Rapid accumulation of wealth in rich households will drive wealth management to 10X size.
3. "The Next Billion" consumer segment will emerge as the largest in numbers and will accentuate the demand for low cost banking solutions.
4. Branches and ATMs will need to grow 2X and 5X respectively to serve the huge addition to bankable population. Low cost branch network with smaller sized branches will be adopted.
5. Mobile banking will come of age with widespread access to internet on mobile.
6. Banks will adopt CRM and data warehousing in a major way to reduce customer acquisition costs and improve risk management.
7. Margins will see downward pressure both on retail and corporate banking spurring banks to generate more fees and improve operating efficiency.
8. Banks will discover the importance of the SME segment for profitability and growth and new models to serve SME segment profitably will be found.
9. Investment banking will grow 10X, driven by demand from corporate for transaction support and capital market access.
10. Infrastructure debt will surpass Rs 45 trillion — half of which will be on bank's books. It will touch the ALM limits of banks and will require a significant upgrade of banks' risk management systems.

The industry is under spotlight to find solutions for two complex challenges thrown at it. One challenge comes from the democratic polity of the nation — to find an economically viable solution for financial inclusion. The second challenge comes from within the public sector banks — to streamline HR in light of rapid loss of talent due to retirements and to energize the workforce for the challenges ahead. This report offers suggestions on possible approaches for banks.

Banks may not succeed in meeting all expectations. NBFCs will play a very crucial role on the extreme ends of the spectrum where there is an innovation challenge — infrastructure finance, rural and agricultural finance, SME finance, and financial inclusion. The role of DFIs will be crucial to bridge market failures in rural infrastructure. Among other things, the government needs to accord the highest priority to the development of a deeper wholesale debt market. Positive regulations are needed to enable NBFC and DFI to supplement banks.

Financial Inclusion: Rising to the Nations Expectations

The level of financial exclusion in India is alarming and the demand for the industry to find a solution is urgent. The IBA–BCG survey of banks revealed that the level of

confidence in finding profitable solutions for financial inclusion is not very high. It is clear that conventional banking models are unviable for low ticket size, zero collateral banking business in this segment. Fortunately, the paradigm has decidedly shifted from "CSR" to "economic viability". Pilots by various agencies — banks, NBFC, MFI, technology players — have demonstrated success in different pieces of the puzzle. Technology is available to support secure and sufficiently low cost transactions. Now, the full solution has to be put together. It is clear that the viable model will be radically different from conventional bank models in terms of distribution, technology, HR practices, and risk management. Banks need to create a business model for financial inclusion from scratch to keep it true to its economic imperatives and ring-fence it from current business to prevent traditional mindset from vitiating it. Should the corporate BC model be allowed, a meticulous alliance with a corporate who has an existing rural presence, can be created. Alternatively, banks can create their own dedicated subsidiaries. These subsidiaries would be viable on a stand–alone basis and would act as the bank's BC. Government needs to support banks with incentives for shared interoperable infrastructure and by reimbursing for government payouts.

Banks can do only so much. Financial inclusion will be meaningless unless the rural economy is stimulated and rural infrastructure is developed. Banks' initiatives have to be supplemented with comprehensive public sector initiatives for rural infrastructure development. There is a gap in India's financial services institutional framework for an institution that can play a pivotal role in financing rural infrastructure with sufficient government backing. NABARD could be repositioned for this role.

Restoring the People Advantage in the Public Sector

Public Sector Banks' (PSB) ability to deliver depends on stream–lining HR. The HR challenge facing the public sector has reached a tipping point. In 2010, the average cost per employee in the public sector surpassed the new private sector. With four decades of legacy to overcome, the solution does not lie in blind adoption of HR practices from the private sector. It requires careful orchestration of eight initiatives — four each to (A) institute discipline and to (B) enhance motivation. The initiatives are:

A1. Steady talent induction: PSBs have exploited productivity enhancement for growth so far, but now they need to induct new talent in large numbers to maintain growth. Recruitment machinery is required to attract talent (as against evaluate applicants) and to retain them through well planned on–boarding programs. Banks also need to explicitly tackle the generation gap.

A2. Sensitive Performance Management System (PMS): PSB social systems are not ready for a conventional PMS that is predicated on high differentiation between individuals. If a PMS is not sensitive to the social context, it will have a negative impact. Banks must start with credible target setting, group based incentive systems, appraiser training, and HR process discipline.

A3. Systemic succession planning and career management: Technology should be used to optimize placements and maintain the skill inventory of the organization. People need to be moved to career tracks that suit their aptitude and the organization's needs. Career committees should be set up to discuss people's careers.

A4. Structural adjustment in cost: New HR practices should be utilized to reduce employee share of total costs.

B1. Empower senior and middle managers: It is the single most important lever to recharge HR. People start exercising their authority only above a minimum critical number of levers of power. Banks must enrich roles, enable people with leadership training, and engage the entire cadres to take up this change as their own.

B2. Massive re–skilling is required at each level for the banks to move from predominantly back office roles to predominantly sales and service roles. Banks need to create "virtual universities" with a very diverse range of programs for each level in hierarchy round the year.

B3. Stimulate non officers: This cadre, which comprises the majority of staff and is younger in average age, needs to be energized with suitable engagement interventions and incentive programs.

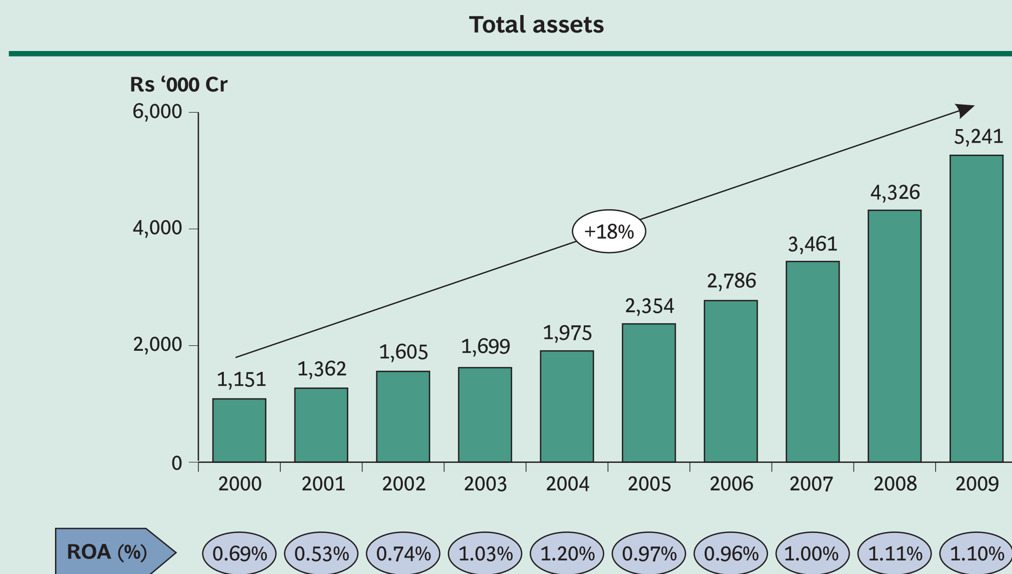
B4. Structured change management: HR departments need new technology and skills. Top management must begin by challenging their own mindset.

Indian Banking 2020: Opportunities and Challenges

Banks in India will be ending the last year of this decade on a high note. A spectacular growth rate coupled with an increase in profitability has led to an impressive performance as illustrated in Exhibit 1a. Financial metrics witnessed a significant improvement. Bad debts fell dramatically. Starting at well above 10 percent in the early 2000s, the gross NPA ratio is currently below 3 percent. The cost to income ratio fell from well above 60 percent to below 45 percent. The Net Interest Margins (NIM) hovered around 3 percent with only a slight dip in the last 2 years as illustrated in Exhibit 1b. Considering the growth prospects of the Indian economy over the coming decade, the banking industry rightfully looks forward to a decade full of opportunities.

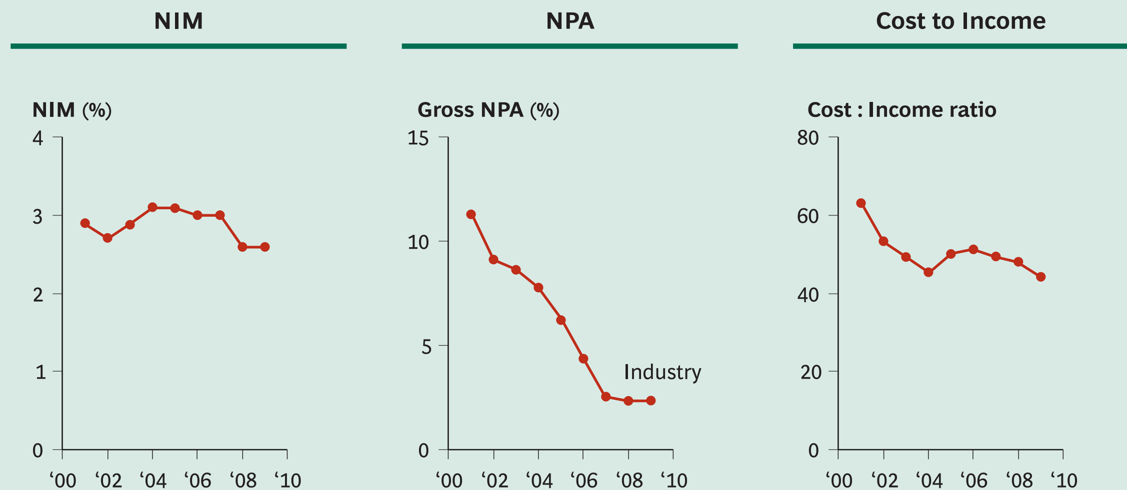
However, there is no dearth of challenges. The banking industry has to live up to a range of high expectations from several stakeholders. The Indian economy stands at a critical juncture of its evolution. Indians look at the next decade with a lot of hope. There are hopes of rapid

Exhibit 1a. The last decade was impressive for the Indian banking industry — Growth with rising profitability



Sources: Annual reports; BCG analysis.

Exhibit 1b. Remarkable improvement in financial metrics — Improvement in quality of assets, operating efficiency, stable margins



Sources: Annual reports; BCG analysis.

growth, inclusive growth, wealth creation, trickle down of wealth, plenty of jobs, better living standards, quality infrastructure, world class Indian companies, world class convenient banking and access to basic banking facilities. Demands from polity to support inclusion are growing shriller by the day. While many Indian industries have demonstrated low–cost innovations that have caught the world's fancy, Indian banks have yet to make a substantive impact. The regulator who has zealously protected the banks' turf for years may be forced to relent in light of the demands for faster development. Weak wholesale debt markets that have kept banks at centre stage of corporate borrowing may finally deepen, leading to pressure on growth and / or margins. Non Banking Finance Companies (NBFCs), who, barring a few exceptions, almost became extinct in the last decade may make a come back. Changing customer preferences and rapid technology evolution could pose challenges to banks in many ways. On top of it, the public sector will face a severe handicap in mobilizing itself unless it addresses its HR on priority.

The following major trends will impact the banks in the form of opportunities or threats over the next decade.

Ten Major Trends that will Shape the Indian Banking Industry

1. Mortgages to cross Rs 40 trillion by 2020:

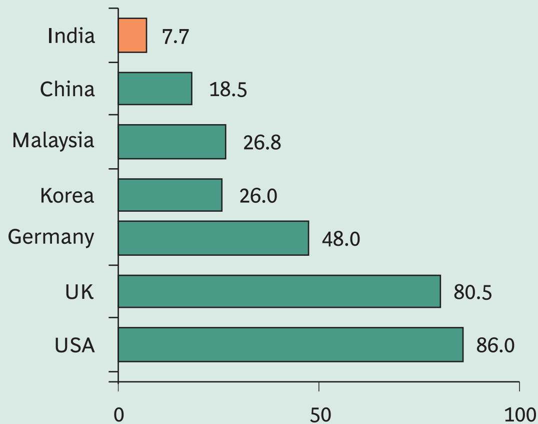
Mortgages typify the retail banking opportunity in an economy. The total mortgages in the books of the banks have grown from 1.5 percent to 10 percent of the total bank advances, in a period of ten years. The ratio of total outstanding mortgages, including the Housing Finance Companies (HFCs) to the GDP is currently 7.7 percent. If by 2020, this ratio were to reach 20 percent, a number similar to that of China, we could expect the mortgage industry growing at an average rate of over 20 percent during the next decade. The outstanding mortgages are expected to cross Rs 40 trillion which is higher than the entire loan book of the banking industry pegged at Rs 30 trillion (as illustrated in Exhibit 1c).

2. Wealth management will be big business with 10X growth:

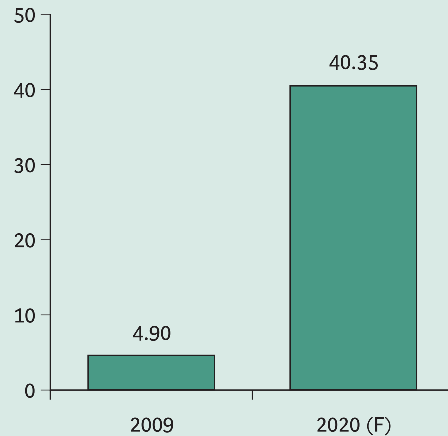
Going forward, wealth is expected to get further concentrated in the hands of a few. As illustrated in Exhibit 1d, the top band of income distribution is expected to grow most rapidly over the next decade. By

Exhibit 1c: Home loans outstanding will exceed Rs 40 trillion by 2020

Mortgage penetration rate



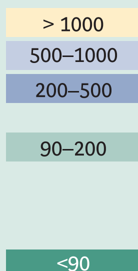
Mortgage loans to cross Rs 40 trillion by 2020



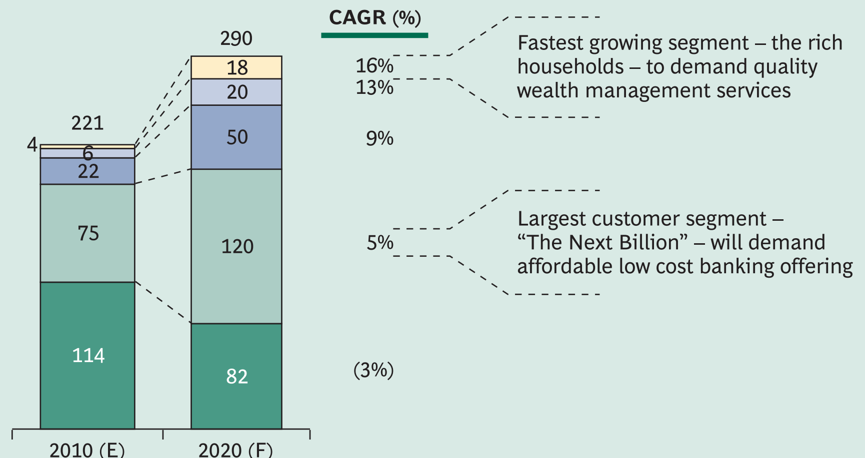
Sources: RBI; IBA; Capitaline; Analyst reports; BCG analysis.
Note: (F) = Forecast.

Exhibit 1d. Evolving Indian income demographics to spur new demands for banking on two ends of the spectrum

Household income Rs '000 per annum



Indian households by income distribution[1] (million)



Sources: BCG estimates; NCAER; BCG analysis.
Note: (E) = Estimate; (F) = Forecast
[1]At constant prices

2020, the top 5 percent house holds, predominantly residing in the metros and Tier I cities, will account for 30 percent of the total disposable income. Wealth management services will be demanded by the nouveau rich and will be an integral part of the product portfolio for both, private as well as public sector banks.

3. "The Next Billion" will be the largest segment:

Also illustrated in Exhibit 1d is the fact that the income group right below the middle class in the annual house hold income range of Rs 90,000 to Rs 200,000 per annum will be the largest group of customers. These customers will be profitably served only with low cost business models having low break even ticket size of business. The next decade would witness banks experimenting with different low cost business models, smaller cost effective branches and new use of technology to serve this segment profitably.

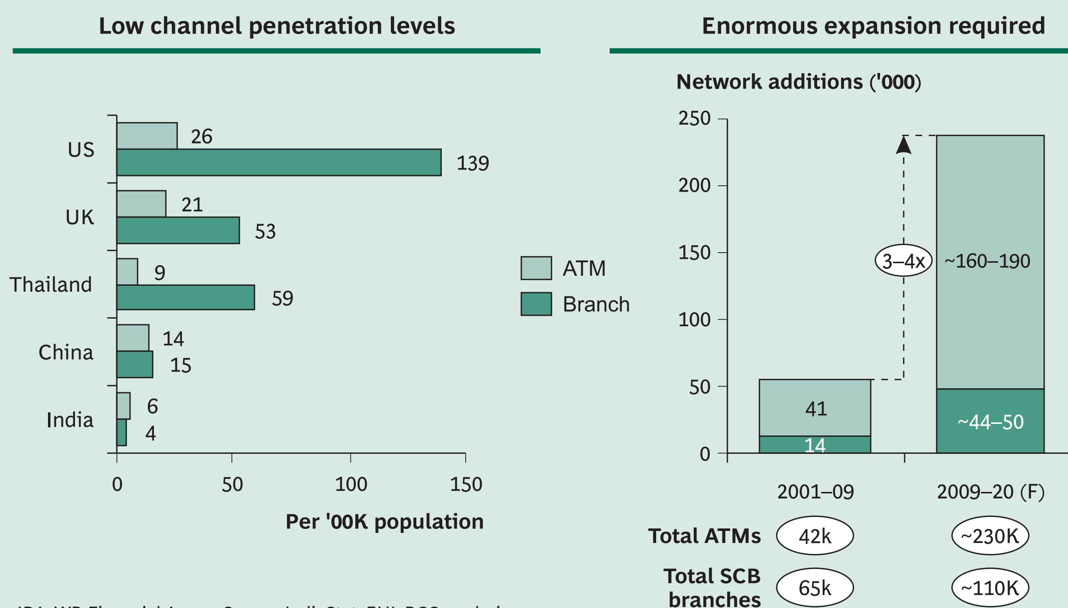
4. The number of branches to grow 2X; ATMs to grow 5X:

India has a very low penetration of branches and ATMs as compared to some of the other developed and developing nations as illustrated in Exhibit 1e. Exhibit 1f highlights the usage pattern of various banking channels in terms of number of visits. It is evident that the bank branches and ATMs are by far the most popular channels, despite a decade of promotion of alternate channels. The experience in developed economies also corroborates that branches and ATMs continue to be the critical channels, although certain transactions have shifted to alternate channels. As such, there is a requirement of at least 40,000–50,000 additional branches and 160,000–190,000 additional ATMs in the coming decade. This will be 3 times more than the branches and ATMs launched in the last decade.

5. Mobile banking to see huge growth and will redefine transaction banking paradigm:

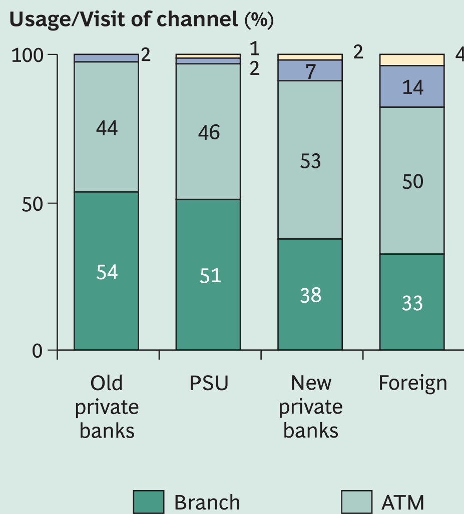
As illustrated in Exhibit 1f, the uptake of internet and call centers is low in all segments other than foreign banks. Comparing with usage pattern in US, the significant potential in online and phone channels is apparent. However, India may evolve differently. The penetration of internet and broad band access in India has been low so far. However, with the advent of mobile banking, the access to banking facilities could completely get revolutionized over the next decade. As illustrated in

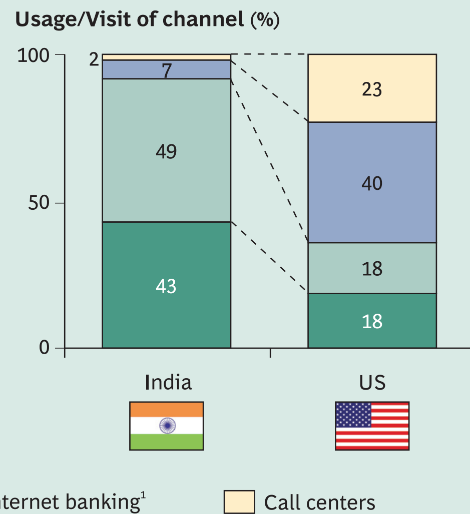
Exhibit 1e. Accelerated expansion in physical banking channels



Sources: IBA; WB Financial Access Survey; IndiaStat; EUI; BCG analysis.
Note: (F) = Forecast.

Exhibit 1f. Internet and phone will be the major banking channels

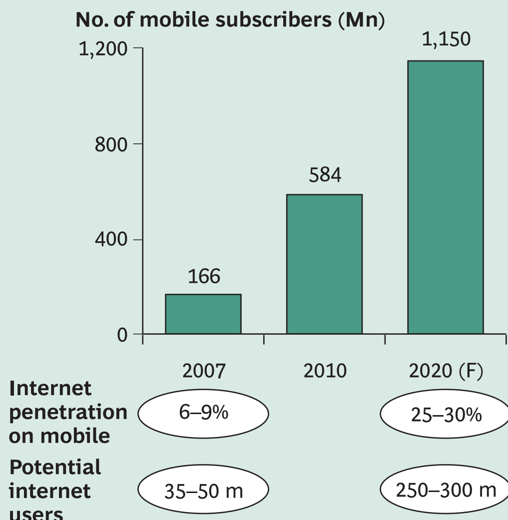


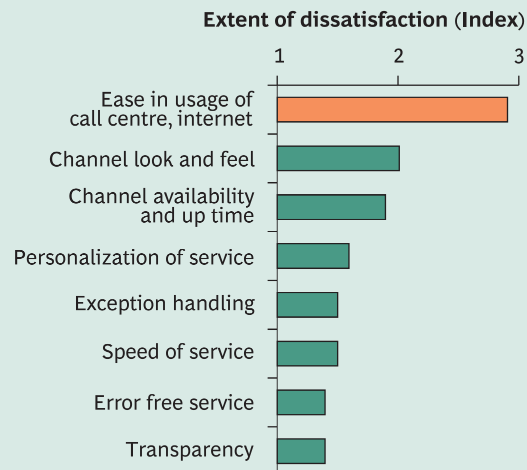


Branch | ATM | Internet banking[1] | Call centers

Sources: NCR; BCG Consumer Survey (N=3,000); BCG analysis.
[1]Includes Mobile Banking.

Exhibit 1g. Significant enhancement in internet / mobile banking required to harness enormous potential





Sources: TRAI; BCG Consumer Survey (N = 3,000); BCG analysis and estimates.
Note: (F) = Forecast.

Exhibit 1g, even if 25–30 percent of mobile users have GPRS / 3G activated, there would be 250 million to 300 million customers who would access banking services over the mobile. On the other hand, customer survey of over 3000 customers in urban areas has indicated that call centers and internet are the most dissatisfying channels. We expect the Indian banking industry to invest significant attention in technology innovation to drive next generation framework for transaction banking. Indian banks could set an example for the rest of the world.

6. Customer Relationship Management (CRM) and data warehousing will drive the next wave of technology in banks:

Exhibit 1h illustrates that the average number of banking products per customer in India is significantly lesser than the global benchmarks. There is a significant potential for cross selling amongst all categories of banks in India. Given that cross selling is highly cost–effective as compared to all other means of customer acquisition, banks will adopt CRM strategies aggressively in pursuit of cost–effective business models described in point 3 above.

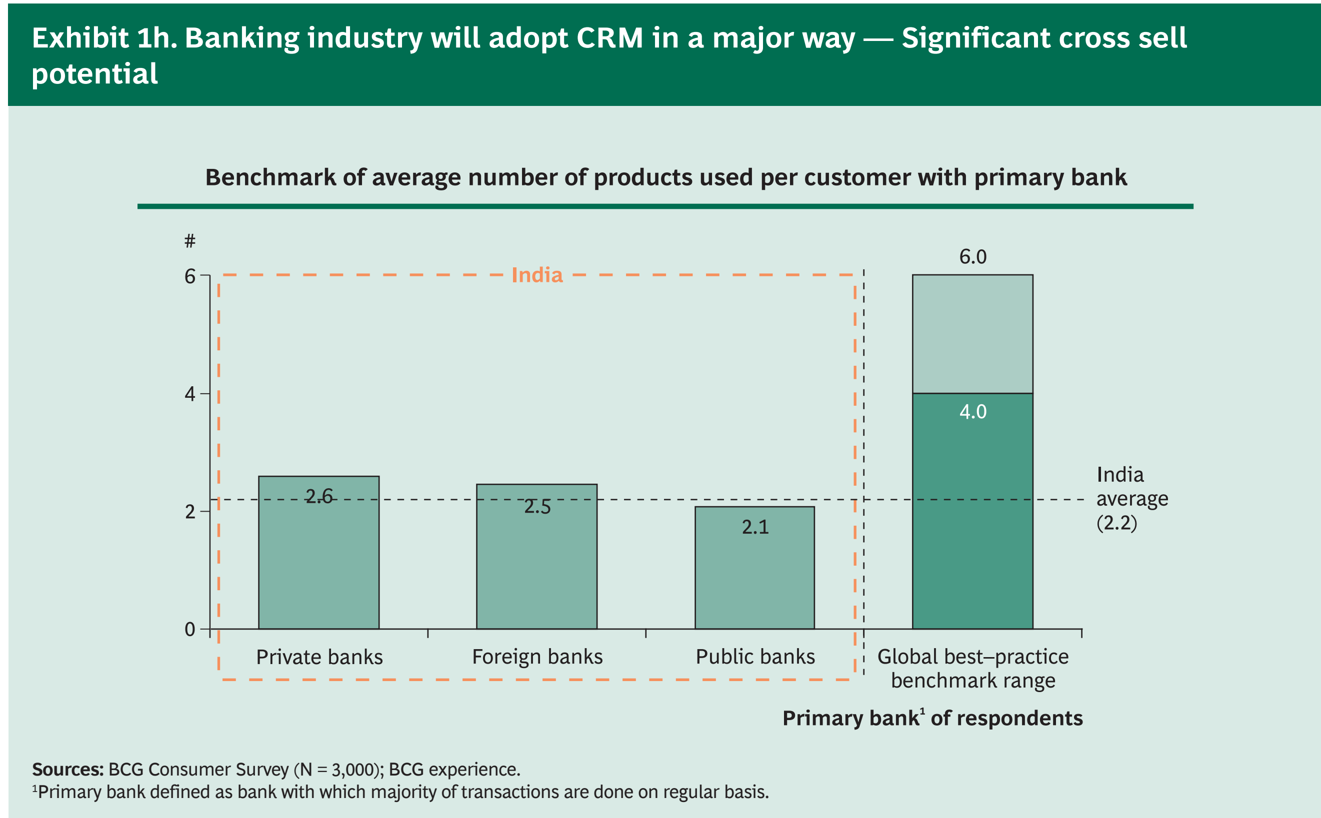
7. Banking margins will come under pressure:

The next decade will see a dramatic change in margins as the wholesale debt markets deepen and corporate customers access the whole sale markets directly. Further, should the savings bank rate be liberalized, banks will move to a regime of low margins. Exhibit 1i illustrates the findings of a recent IBA survey conducted across banks to understand their perception of the future trends. The public sector banks expect to see their margins squeeze with a much higher likelihood as compared to the private sector / foreign banks. Exhibit 1j illustrates the actual NIM of the public sector banks and private sector banks over the last 5 years. The NIM of the public sector banks has consistently declined and this perhaps reflects in the pessimistic view on future margins adopted by the public sector.

8. New models to serve the Small and Medium Enterprises (SME):

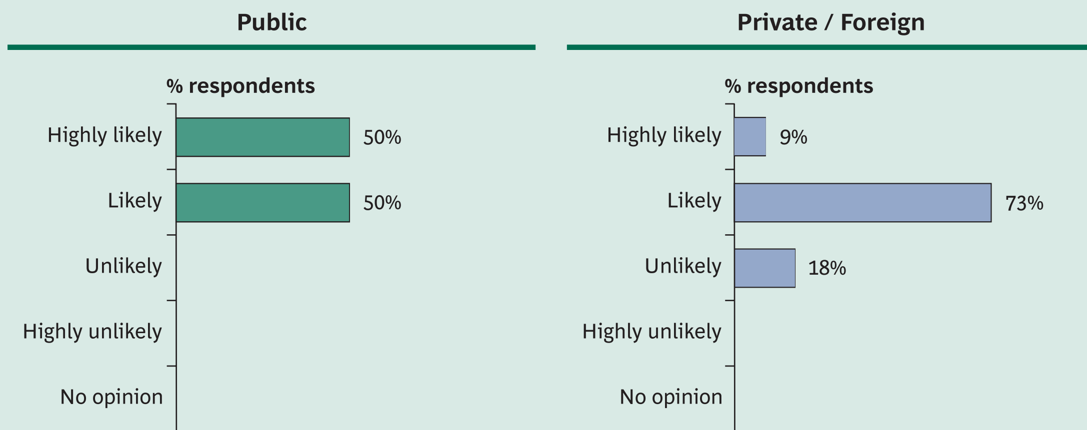
Exhibit 1k illustrates the results of a survey conducted by FICCI to gauge the level of satisfaction among large, medium and small business customers with regard to banking services. The large customers are more satisfied

Exhibit 1h. Banking industry will adopt CRM in a major way — Significant cross sell potential



Sources: BCG Consumer Survey (N = 3,000); BCG experience.
[1]Primary bank defined as bank with which majority of transactions are done on regular basis.

Exhibit 1i. Public sector sees bigger threat of margin squeeze

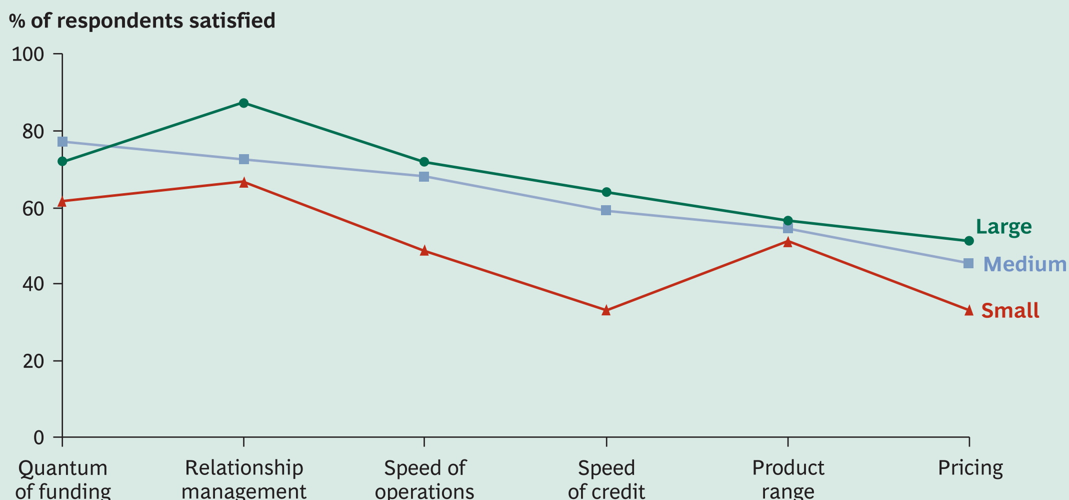


Sources: IBA – BCG Survey of Banks.
Note: Sample size: 13 PSU banks, 7 Private banks, 4 Foreign banks.

Exhibit 1j. Net Interest margin of banks by segment

Sources: Annual reports; BCG analysis.

Exhibit 1k. Banks will need to innovate to meet the expectations of SME customers



Sources: FICCI – BCG Survey (N=100).

across all dimensions as compared to the medium and small sized ones. The smallest businesses are most dissatisfied. Due to higher risk and lower ticket size, the SME typically get less attention. Banks are yet to create innovative models to serve SMEs with sufficient and timely credit at the right price. In general, the level of dissatisfaction is higher on pricing and product range. A further analysis highlights that the dissatisfaction on pricing is higher for the private sector banks while dissatisfaction on product range is higher for the public sector ones. As the yields in large corporate banking falls with further deepening of wholesale debt markets, the banking industry in India will find cost–effective ways to serve the SME customers where yields are quite high. Exhibit 1l highlights the top 3 new expectations of business customers in the next decade, as per our recent survey. The SMEs hope to get the basics — good relationship management, fast credit decisions and a complete product range all at one place.

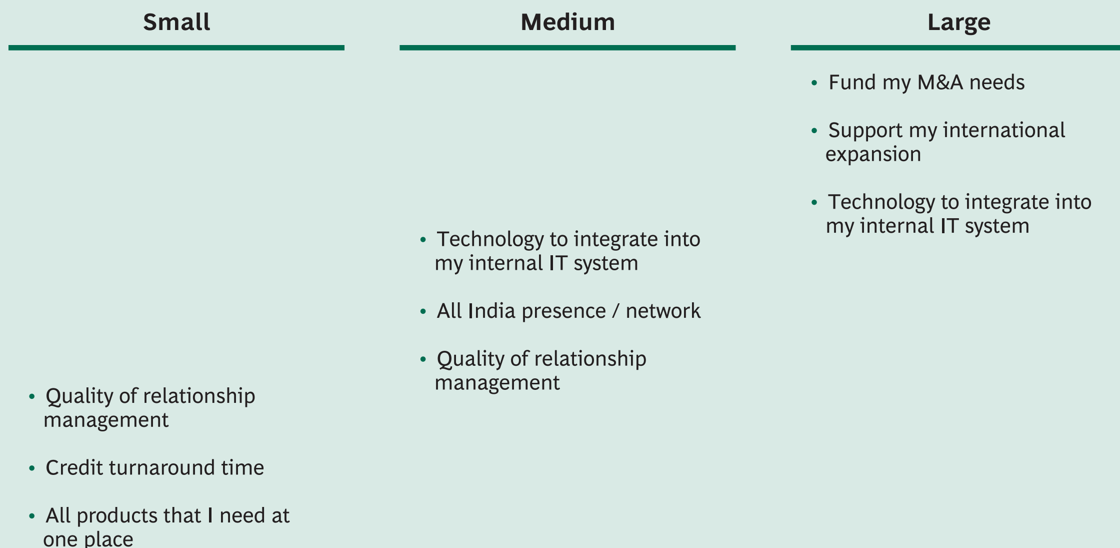
9. Investment banking will grow over ten–fold:

Investment banking will be among the fastest growing segments in the banking industry rising from 4 percent to 7 percent of the entire corporate banking revenue pool. The larger corporate customers expect to demand higher support for international expansion and mergers and acquisitions over next decade as shown in Exhibit 1l. Further, as the wholesale debt markets deepen, the larger corporates would avail of advisory and capital market services from banks to access capital markets. The revenue pool will shift from traditional corporate banking to investment banking and advisory. Banks with international presence stand to benefit.

10. Infrastructure financing to hit over Rs 20 trillion on commercial banks books:

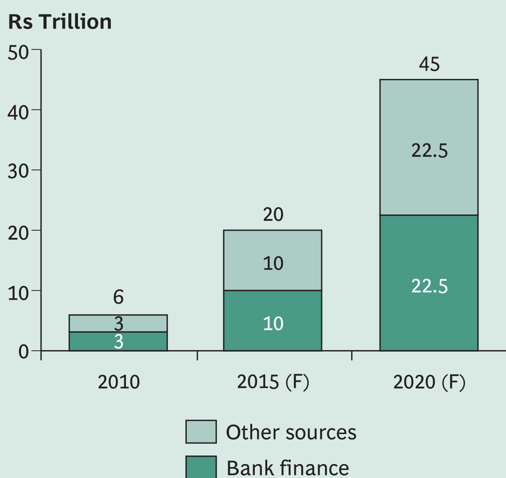
As India continues to rely on private funding for infrastructure development, infrastructure will occupy a larger share of the balance sheets. Half of the debt finance for infrastructure today comes from banks. As illustrated in Exhibit 1m, by 2020 banks would have accumulated infrastructure assets worth Rs 20–25 trillion on their books. This would touch 12–15 percent of the total advances. Infrastructure loans coupled with home loans would together account for about 25–30 percent of the total advances of the banking industry. This would be the limit to which banks will be comfortable taking

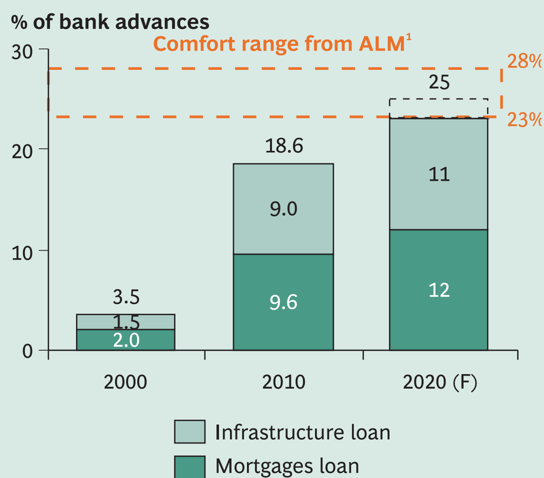
Exhibit 1l. Top 3 "new" expectations from banks in the next decade



Sources: FICCI – BCG Survey (N=100).

Exhibit 1m. Banks will hit their limit of long term lending with infrastructure and mortgages — Need to address concentration risk





Sources: Bank annual report; BCG analysis.
Note: (F) = Forecast.
[1]Assuming 50–60% of CASA deposits are long tem; 75% CD ratio.

long term assets on their books. Even as the asset liability mismatch issues are resolved by IIFCL and the government, the real challenge for banks would be to develop skills to undertake the risks of long gestation infrastructure projects and manage concentration risk in infrastructure.

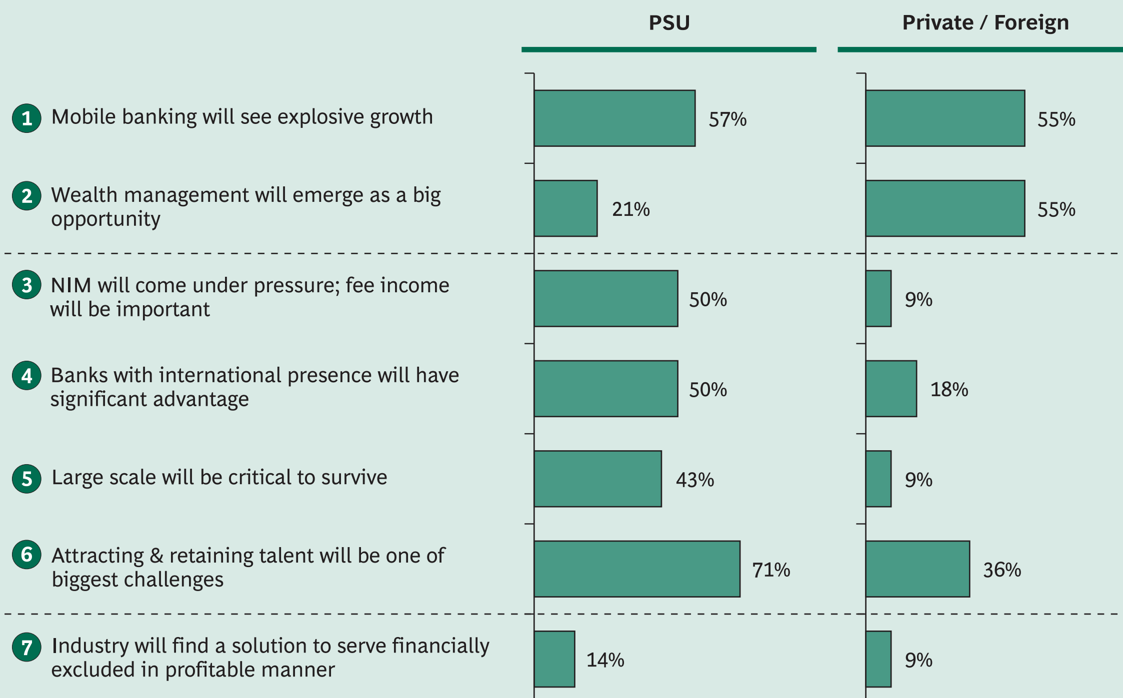
Two Challenges of the Decade

There are two areas in which the Indian banking industry will be severely challenged to find a solution over the next decade. First pertains to the rising expectation from banks to find an economically viable solution for financial exclusion. The second pertains to human resources challenge in the public sector. While the first challenge demands unusual innovation and experimentation, the second threatens to cripple the ability of the largest segment of the banking industry from being able to innovate and stay competitive. It is unclear that the solutions to these two challenges will be identified unless the banks were to accord highest priorities to these and work in concert.

1. Financial inclusion:

The issue of financial inclusion is at the centre stage of the agenda of the government. While the expectation from banks is high, the government is also starting to look at non banking industries to come forward with a solution. Needless to say, if the answer does not come from banking industry, non banks will be welcome to nibble at its revenue pool. It is a strategic priority given that the customer segment in question will be the largest in number over the next decade and banks stand to lose this relationship. As illustrated in Exhibit 1n, the banking industry in not very confident of finding a solution. This topic is dealt in detail in Chapter 2.

Exhibit 1n. Bankers' expectations vary



Sources: IBA – BCG Survey of Banks; BCG analysis.
Note: Sample size: 13 PSU banks, 7 Private banks, 4 Foreign banks.

2. The HR challenge in the public sector:
The public sector banks enter the next decade with the same expectations as their private sector peers but with a severe disadvantage in human resources. The HR challenge of public sector banks has reached a tipping point. Due to a legacy of several decades, the public sector banks will witness unprecedented loss of skills and competencies in form of retiring senior and middle management executives over the next few years. That coupled with the need for large scale re–skilling, attracting and retaining fresh talent, controlling the growing employee costs, and introduction of performance discipline are significant challenges. As illustrated in Exhibit 1n, the public sector banks are almost unanimous in their concern about the future challenges of attracting and retaining talent. This issue is further discussed in detail in Chapter 3.

Bankers' Expectations Vary

Exhibit 1n summarizes the views of the public and private sector / foreign banks captured by a recent survey conducted by IBA. The survey responses highlight perceptions that converge on some issues and diverge on others. The responses capture anxieties of banks regarding certain challenges in the next decade.

- Both sectors agree to different degrees on the potential of mobile banking and wealth management. The public sector perceives a higher imminent threat from squeezing margins and believes that there is a need to scale up and expand globally. The private sector, on the other hand, believes that the margins are reasonably secured and feels a relatively lesser need for international presence and scale.

- Despite the recent hectic activity on financial inclusion, 14 percent of the public sector and 9 percent of the private sector banks feel that it is "very likely" that a profitable model of financial inclusion will be arrived at by the industry. However, 36 percent of the public sector banks and 27 percent of private sector banks feel that their bank will be participating in financial inclusion in a profitable manner.

- Finally, there is utmost unanimity amongst public sector banks that attracting and retaining talent will be the biggest challenge. Overall, the public sector appears more paranoid about the future of their competitiveness while the responses from their counterparts in the private sector are more sanguine.

Crucial Role for NBFC and DFI

Encourage NBFC in specialized segments
Banks may not be able to live up to all expectations. There are many opportunities that are easy to capture but there are also many that require significant innovation or specialized skills that conventionally not banks' strengths. The latter opportunities are at the extremes of spectrum. Very large ticket, long term infrastructure lending requires risk management expertise that goes beyond traditional credit appraisals at banks. There will be significant space for specialized entities in risk assessment and structuring of infrastructure finance. Very low ticket unsecured credit requires sophisticated risk management and cost control that is not easy in business model of conventional banks. Gaps in SME finance can be filled with asset based lending, operating leases, and factoring. Specialized NBFCs can play a major role in all of these. These are niches. But each one of them is individually large to sustain significant balance sheets. Importance of NBFC needs to be recognized to make the decade's promise come true for India. Positive regulatory environment to support NBFC will be crucial.

Rural infrastructure needs a government backed DFI to address market failures
Financial inclusion is being pursued as a crucial driver of inclusive growth. However, financial inclusion is necessary but not sufficient. Sustainable inclusive growth requires financial inclusion to be supplemented (if not preceded) by rural infrastructure development and stimulation of rural economy through livelihood generation interventions. While commercially viable models are being encouraged for financial inclusion, the same is not possible in the case of rural infrastructure development and livelihood generation. Market failures abound. Currently rural infrastructure is supported by government through myriad agencies and departments — NABARD (through RIDF funding to states), MoRD (through PURA and PPP initiatives), REC, various state government agencies, etc. India needs a pivotal agency with appropriate government backing to finance rural infrastructure. No DFI across the world survives without access to cheap source of funds supported by the government.

In the current institutional landscape of India, NABARD is most suited to play this role. It already channelizes RIDF funds to states for rural infrastructure development. However, RIDF funds are hardly sufficient for the purpose and need to be augmented. NABARD supported rural infrastructure development is credited to be higher quality compared to initiatives of state government due to higher standards of quality control and emphasis on livelihood generation and citizen participation. Explicit government financial support to NABARD has to be strengthened. NABARD has to be restructured to expand the breadth of its product portfolio from simple loans to state governments to structured finance options that meet needs of not only different state governments and but also private sector which will participate in select segments of rural infrastructure through PPP route.

Financial Inclusion: Rising up to the Nation’s Expectations

The future of democratic polity and social harmony of India rests on the premise of inclusive growth. Financial inclusion is a crucial driver for such growth. The political leadership is looking at the banking industry to deliver on this promise over the next few years. Already, additional competition is planned in the form of new licenses for private sector banks in the hope that this will lead to innovative business models for inclusive banking. This expectation will strengthen. Delay in solving the issue could lead to the banking revenue pool being opened up to non banks to find more creative answers.

Many studies and reports have highlighted the issue of financial exclusion. Based on research conducted by The Boston Consulting Group in 2006, 144 million households are financially excluded. As per the 2008 Report on Financial Inclusion by Dr. C. Rangarajan, over 73 percent of farmer households currently do not have access to formal sources of credit. In certain geographies this ratio is much worse.

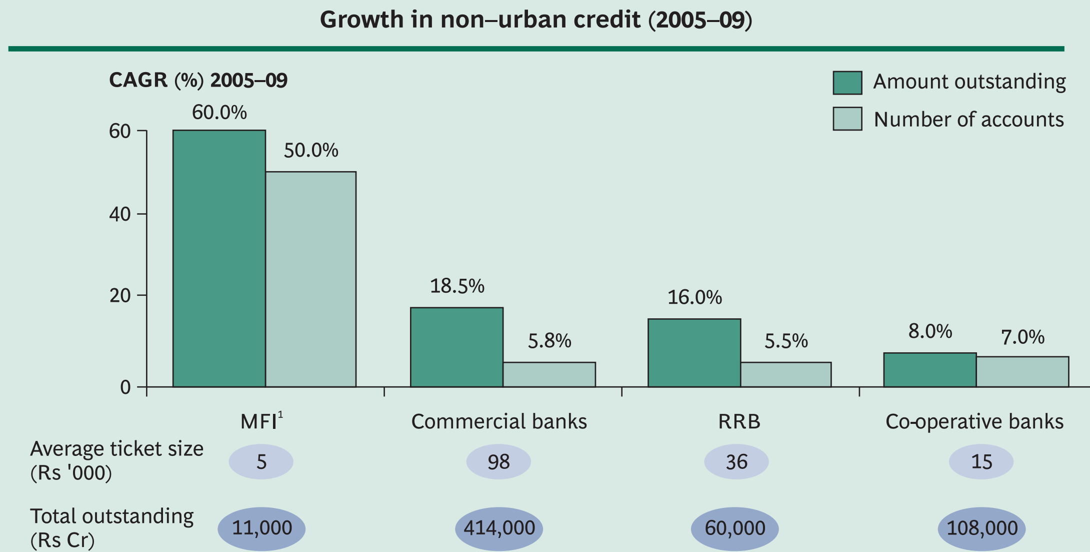
Various experiments — by banks and non banks — have served to highlight the broad contours of the potential solution. The philosophical framework to fight financial exclusion has undergone a significant shift from an “obligation” perspective to an “opportunity” perspective. It is also well established that a down graded conventional banking model is not the answer.

Learnings from What Works — Collating Pieces of the Puzzle

Exhibit 2a shows the growth in outstanding credit and the number of accounts between 2005 and 2009 within the different segments of the industry in rural and semi urban areas. Commercial banks and RRBs have recorded a growth in credit of 18.5 percent and 16 percent respectively. However, the growth in the number of accounts is far behind at 5.8 percent and 5.5 percent respectively. The average size of loans is high and has been rising. Clearly the banks find it unviable to lend to smaller borrowers in rural and semi urban areas. On the other hand, the growth in credit of the MFIs’ and co–operative banks matches the growth in the number of accounts. This implies continued lending to smaller borrowers. Their average size of a loan account at Rs 5,000 and Rs 15,000 is substantially smaller than those of commercial banks and RRBs which are at Rs 98,000 and Rs 36,000 respectively. The SHG Bank linkage program that mimics the MFI model in the commercial bank framework has not kept pace with the MFI industry.

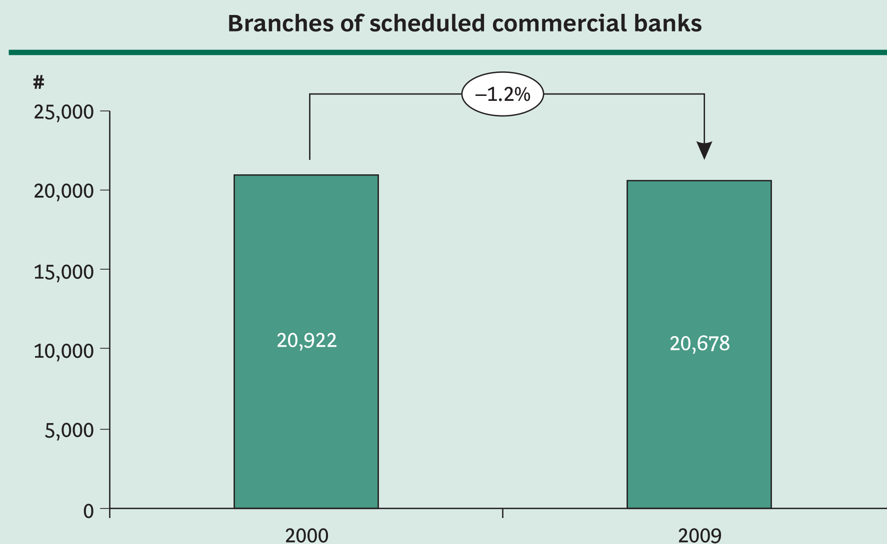
The current business model of a commercial bank has a cost structure that is economically unviable for rural markets. During the last decade, the total number of rural branches of commercial banks dropped by 1.2 percent (as shown in Exhibit 2b), whereas, co–operative banks and MFI demonstrate elements of business models that are economically viable for small ticket lending. The stunted growth of co–operative banks reflects the weakness in their governance framework, capability deficits, and poor financial strength. This is being rectified under the Vaidyanathan Committee (VC1) implementation. The MFI industry has been growing at a scorching pace of over 50 percent. This could create trouble with bad debts. Never the less, the phenomenal growth the of MFI segment does reflect the huge unmet demand and the suitability of some elements of the MFI business model for that demand.

Exhibit 2a. Non–urban credit landscape demonstrates the efficacy of different models



Sources: RBI BSR, NABARD, M–CRIL, BCG analysis.
Note: For commercial banks and RRB the data pertains to semi–urban and rural business.
[1]Growth rates for MFI 07 to 09.

Exhibit 2b. Number of branches of commercial banks in rural areas reduced over last decade



Sources: Annual reports; BCG analysis.
Note: SBI, Nationalized banks, Old private sector, New private sector, Foreign.

Banks should adopt some key elements of the MFI model as they design a viable model to serve the financially excluded.

A Business Model Starting from a Clean Slate

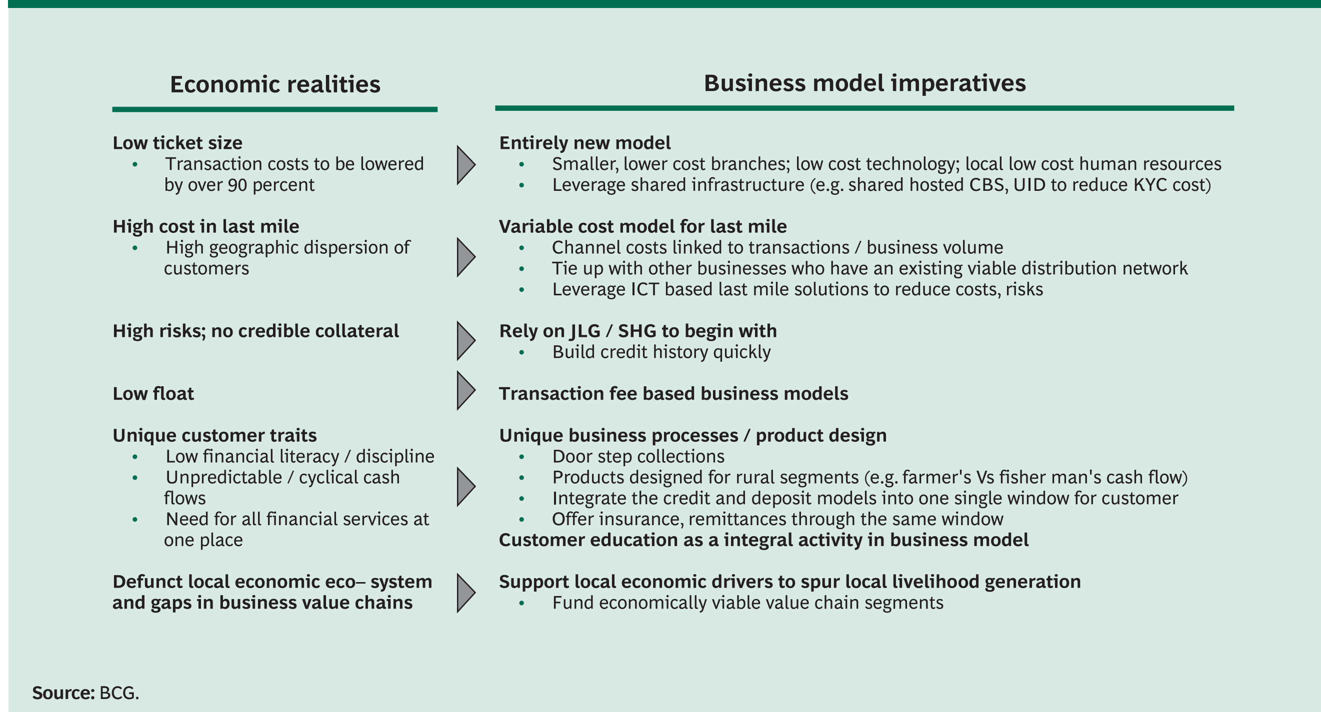
The business model to profitably serve excluded customers will be significantly different from a conventional bank model. It needs to be created from a clean slate to prevent existing models from influencing the design. Also the model will need to be ring–fenced for it to stay true to the underlying business imperatives.

First, not all excluded customers can be served profitably. Research by The Boston Consulting Group in 2006 found that a large segment of customers just above the bottom of the pyramid are excluded from formal financial services. They could be profitably served with an innovative low cost business model. This segment, with annual household incomes in the range of Rs 60,000–180,000 is termed “The Next Billion” segment. The business models to serve customers at the bottom of the pyramid will require state subsidies and support.

Exhibit 2c depicts the imperatives for this new business model. Transaction costs must be reduced by as much as 90 percent to achieve a sufficiently low break–even to accommodate the low ticket sizes. Such dramatically lower costs require the entire business model to be created bottom up from scratch — with different technology, local low cost manpower, much smaller branches, simple product portfolio and processes. Shared infrastructure has to be leveraged wherever possible. In its report on the use of mobile phones for financial inclusion, the Inter–Ministerial Group has envisaged a shared account–hosting infrastructure to reduce the cost of technology for very small balance accounts. UIDAI infrastructure would reduce KYC costs in new customer acquisition.

The second challenge is reducing the last mile cost, which is very high due to significant geographic dispersion of customers. Technology now allows online BC models that enable real time transactions at very low costs as illustrated in Exhibit 2d. An ICT enabled online BC allows for rich customer interaction at one–tenth the transaction cost of a typical branch. “For Profit” Corporate BC is under active consideration of the regulator. Such a

Exhibit 2c. “No frilling” of conventional models not sufficient — Banks need to create a business model from a clean slate



Source: BCG.

partner who already has a viable distribution network in rural areas could help create a very low cost BC model at marginal cost.

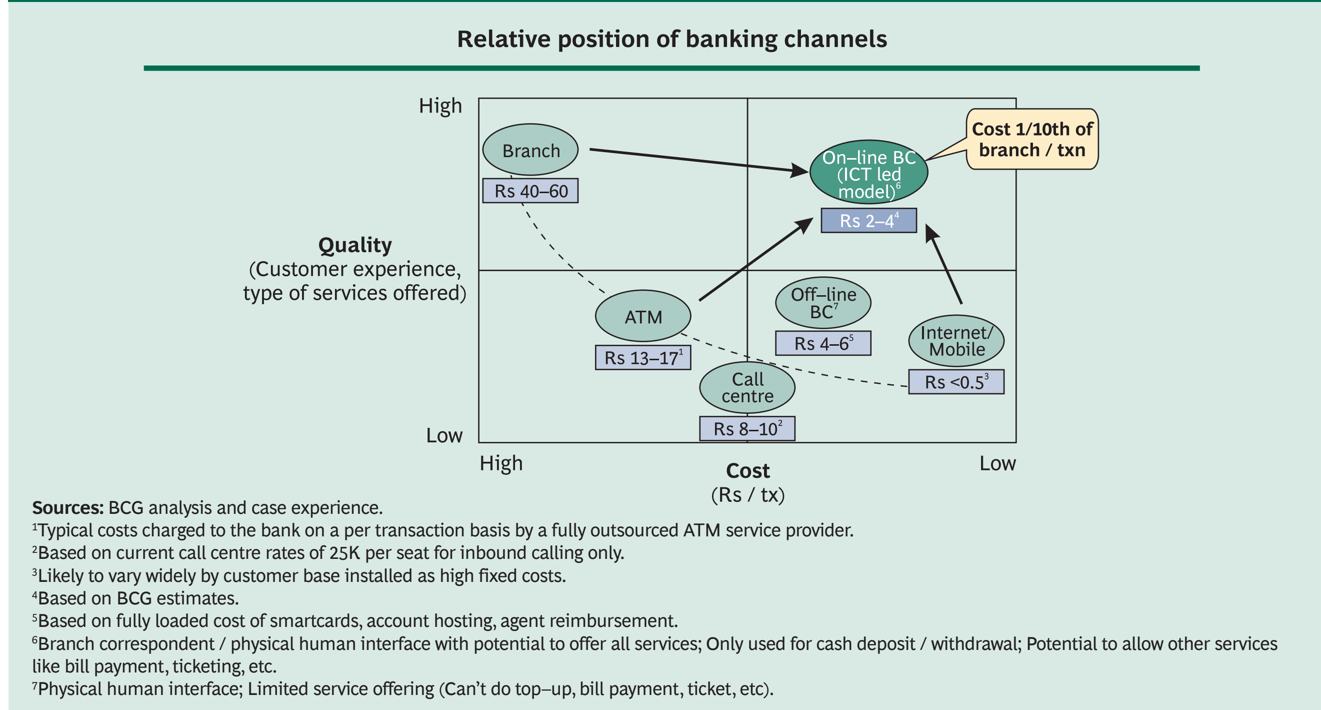
The third challenge pertains to credit. Credit is by far the most sought after product and also the most profitable. However, there is typically no collateral to support securitized lending. The business has to start with using the JLG / SHG approach while in parallel developing the credit history of individuals such that promising entrepreneurs could be supported with higher volumes of credit over time.

The fourth relates to with pricing. Typically banks earn revenues on transaction products with a float income. However in this segment, floats are very low so the business model will need to be based on transaction charges. Fortunately, there is wide spread acknowledgement that prices should be remunerative. The pricing scheme has to be designed in a manner that customers perceive as fair.

Product and process design will also need to be different from the traditional mass market banking practice. For example, successful rural banking businesses have found that sending collection staff door–to–door with hand –held online devices is particularly effective. Rural households are segmented in terms of their cash flow profile. "Farmers" have high risk cyclical incomes. "Fishermen" have daily volatile incomes. Products need to be designed to suit customer's different cash flow profiles. Rural households value access to all financial products and advise under one roof. Banks need to co–locate the credit and deposit businesses within the same channel to meet the needs of these customers.

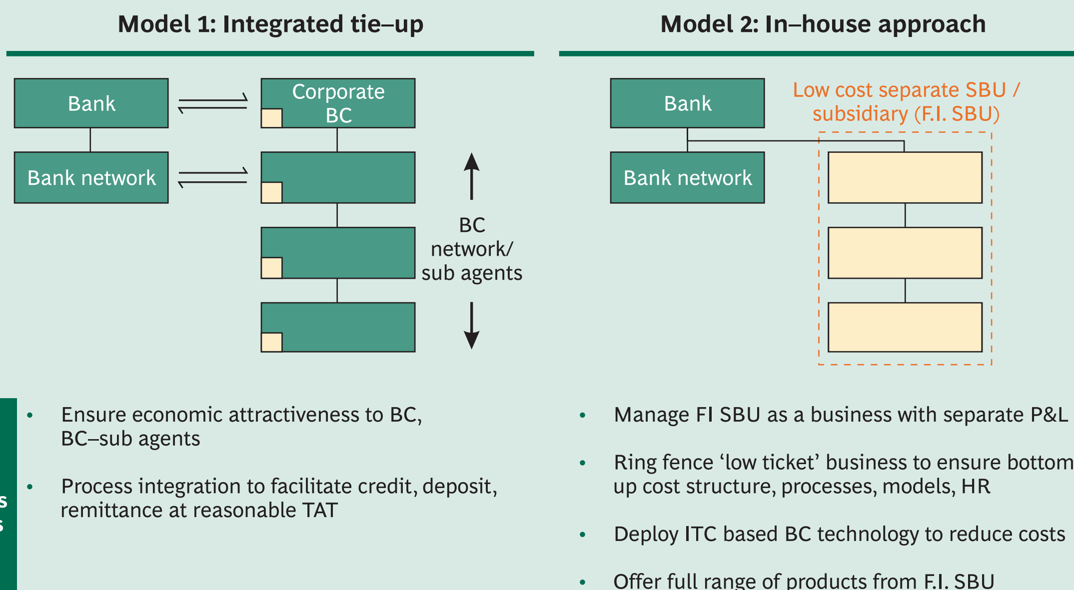
The final imperative is the most crucial one. In this segment, steps to achieve financial literacy are an integral part of the business plan. This is in the best interest of the bank, as well as the customer. Further, the bank's business model needs to acknowledge that the long term viability of the business depends upon economic improvements in the ecosystem of the customers to ensure that their livelihoods are sustainable. As such, the bank's business plan needs to go beyond the products and services to the customers and support / finance local economic drivers and agricultural value chains.

Exhibit 2d. Technology is allowing sufficient lowering of transaction costs while maintaining the quality of interface



Sources: BCG analysis and case experience.
[1]Typical costs charged to the bank on a per transaction basis by a fully outsourced ATM service provider.
[2]Based on current call centre rates of 25K per seat for inbound calling only.
[3]Likely to vary widely by customer base installed as high fixed costs.
[4]Based on BCG estimates.
[5]Based on fully loaded cost of smartcards, account hosting, agent reimbursement.
[6]Branch correspondent / physical human interface with potential to offer all services; Only used for cash deposit / withdrawal; Potential to allow other services like bill payment, ticketing, etc.
[7]Physical human interface; Limited service offering (Can't do top–up, bill payment, ticket, etc).

Exhibit 2e. Approaches for viable financial inclusion models — Need to ring–fence financial inclusion business



Source: BCG.

Ring–Fence Financial Inclusion — Two Approaches for Banks

We are at the cusp of the evolution of viable business models for "The Next Billion" customers in the banking industry. Different pieces of the puzzles are coming together through a variety of experiments and pilots at different places. The task is to pull it all together into a consistent, viable business model for the banks. Given that the business model for this segment will be substantially different from that of a traditional bank, it will be crucial to ring–fence this business. The banking industry should draw learnings from the airline industry where companies often create a separate low cost airline to capture the entire range of customers. There are two broad approaches as depicted in Exhibit 2e.

The integrated tie–up model is based on the possibility that corporate BC may be permitted by law soon. The model envisages a highly integrated alliance between the bank and its corporate BC. The processes, roles, and pricing have to be meticulously worked out to ensure an attractive value proposition for the corporate BC as well as the sub agents of the corporate BC. Like all alliances, the challenge of creating a model that keeps the business partner interested over time is significant.

In the in–house approach, the bank will ring–fence the Financial Inclusion business unit into a separate SBU with separate P&L, organization, and HR. This is to ensure that the business model can be created without any bias from the existing practices and mindset of the current business model. The business model should draw on the best practices from various successful pilots deployed inside the bank.

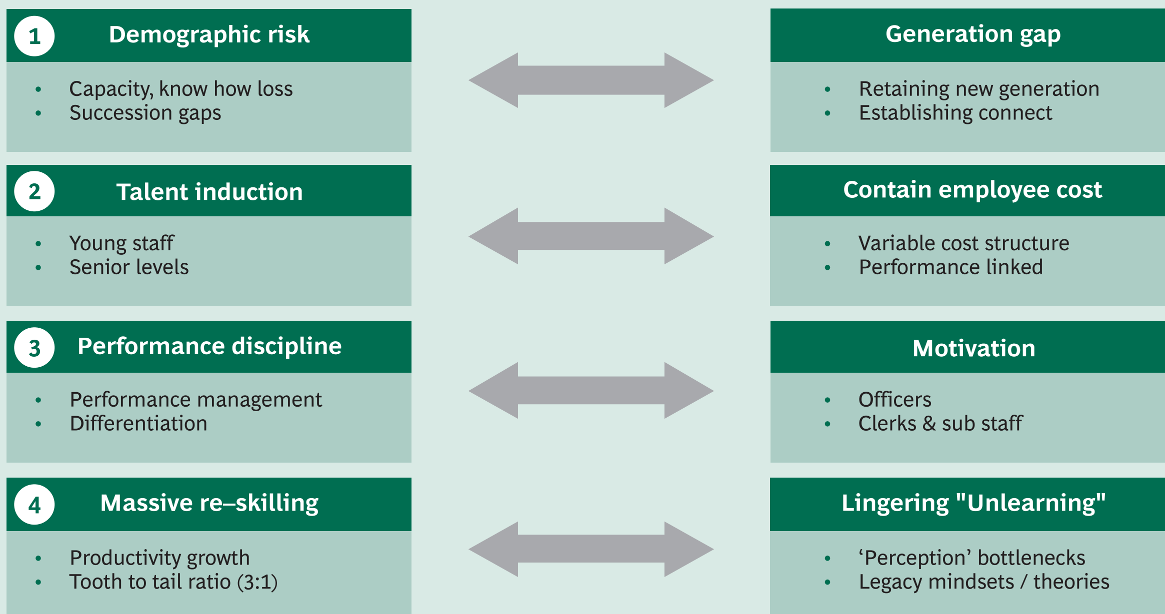
Restoring the People Advantage in the Public Sector

Acquiring and retaining talent is the most critical challenge facing the banking industry, especially for the Public Sector, Units (PSU) where the situation is most urgent. A four decade–long legacy shaped by the constraints of state ownership, and short tenures of top management has created a precarious instability PSU banks' Human Resource (HR). The diminishing people advantage of the public sector banks has to be restored with urgency. This crisis has reached a tipping point, and the competitiveness of the entire sector hangs in the balance. Most importantly without addressing its HR issues, the public sector cannot rise to the challenge of financial inclusion in any meaningful manner.

Unique Complexities in the Public Sector

Conventional HR measures are ineffective in the face of the steep challenges faced by the public sector. This is due to a set of four concurrent pressures that strain existing HR frameworks, as shown in Exhibit 3a.

Exhibit 3a. Conflicting concurrent demands — Conventional HR interventions will not be effective

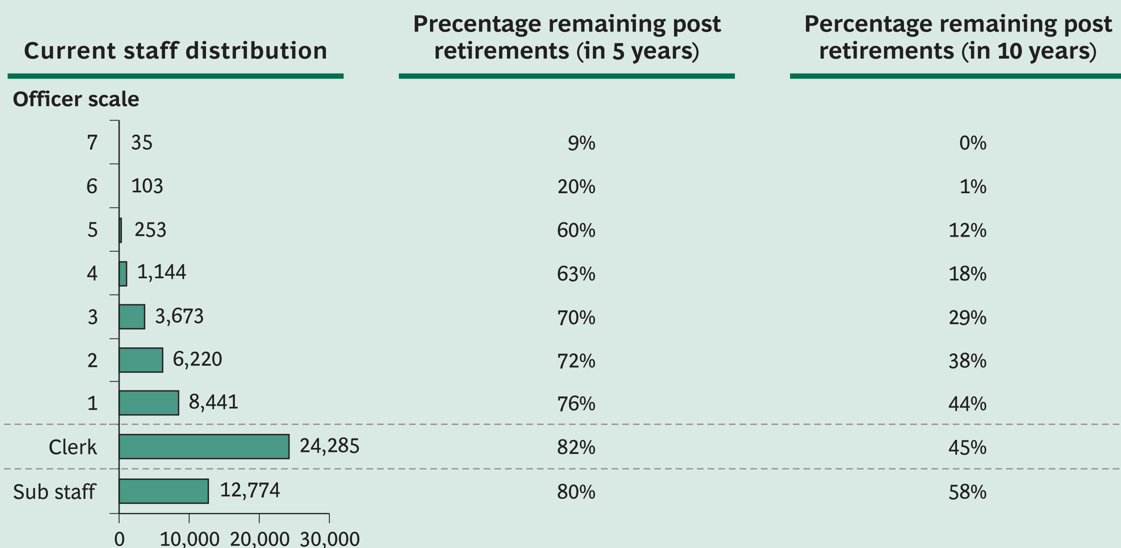


Source: BCG analysis.

First is the most imminent challenge of demographic risk. With a significant number of senior and middle management executives due to retire over the next few years, the leadership pipeline is perilously thin. Exhibit 3b illustrates the problem for a typical large public sector bank. Almost 80 percent of middle management and 50 percent of the junior–most officers will be lost through retirement within the next 10 years. Crucial competencies and know–how will be lost with the departing executives. The flip side of this challenge is illustrated in Exhibit 3c, which illustrates the yawning generation gap that will emerge at a typical public sector bank over the next five years. If aggressive recruiting from the younger population is undertaken, the ranks of the 20–30 year age group will swell; at the same time, the majority of the remaining workforce will fall into the 50–60 year age group. This emerging manpower profile will leave a generation gap between the young cohort of new hires and the experienced employees to whom they would report. Such a gap creates a disconnect that threatens to damage the assimilation and retention of the new recruits.

This raises the second major HR challenge facing public sector banks today: the banks have to induct talent in large numbers of fresh employees to retain their competitive edge and market share. The private sector banks, even excluding their outsourced staff, are among the top employers today with comparable employee strength to the public sector banks, as illustrated in Exhibit 3d. But perceptions have not kept pace with the speed of change, and most people retain the outdated belief that the public sector workforce is highly unproductive. The reality is far from it. As illustrated in Exhibit 3e, most public sector banks have doubled their revenue per employee in the last three years. Today, the productivity of the public sector banks is comparable to that of their private sector counterparts. Those private sector banks that appear most productive typically outsource a significant part of their manpower. If outsourced manpower is factored in, the productivity gap would shrink. Exhibit 3f illustrates the productivity of PSU banks as compared to key private sector banks on the basis of employee strength on rolls. There is one key difference however: the aging profile of public sector manpower cannot match that of the private sector in product segments that require aggressive selling or significant technology dexterity. Aiming for 100 percent parity is not feasible.

Exhibit 3b. Demographic risk of a typical large public sector bank

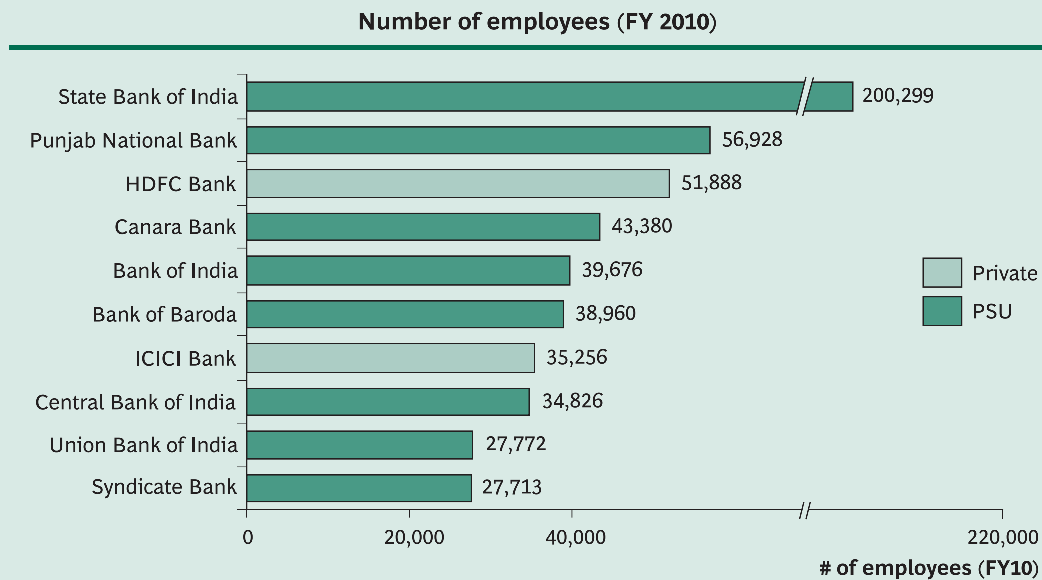


Source: A large nationalized bank.

Exhibit 3c. Yawning generation gap

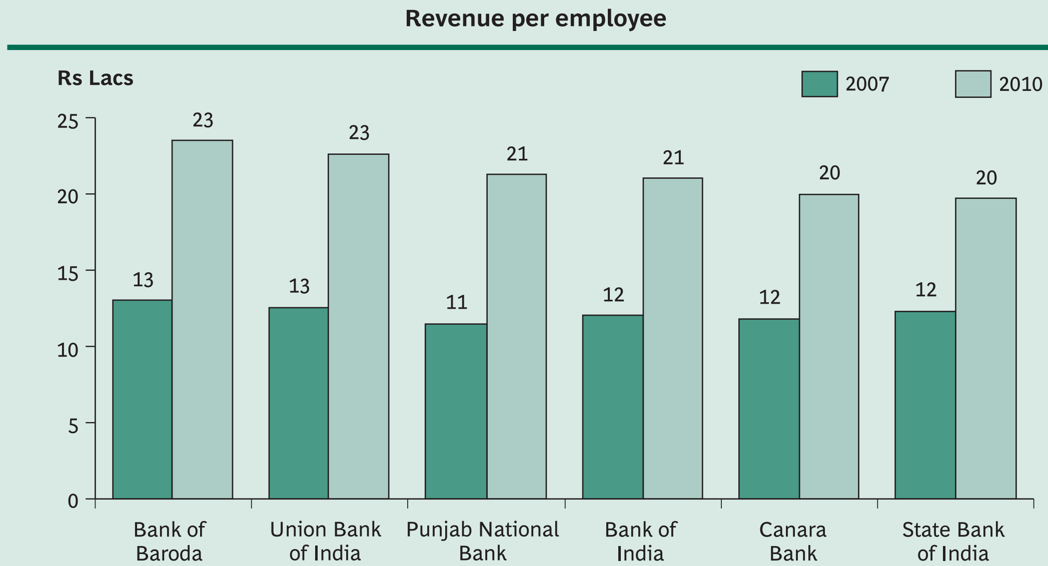
Sources: IBA; BCG analysis.
Note: Assumption 80% of new hires between 20–30 years of age and 20% between 30–35 years.

Exhibit 3d. Public sector banks are not the only large employers — HDFC Bank is the third largest employer in the industry, others have a significant outsourced head count



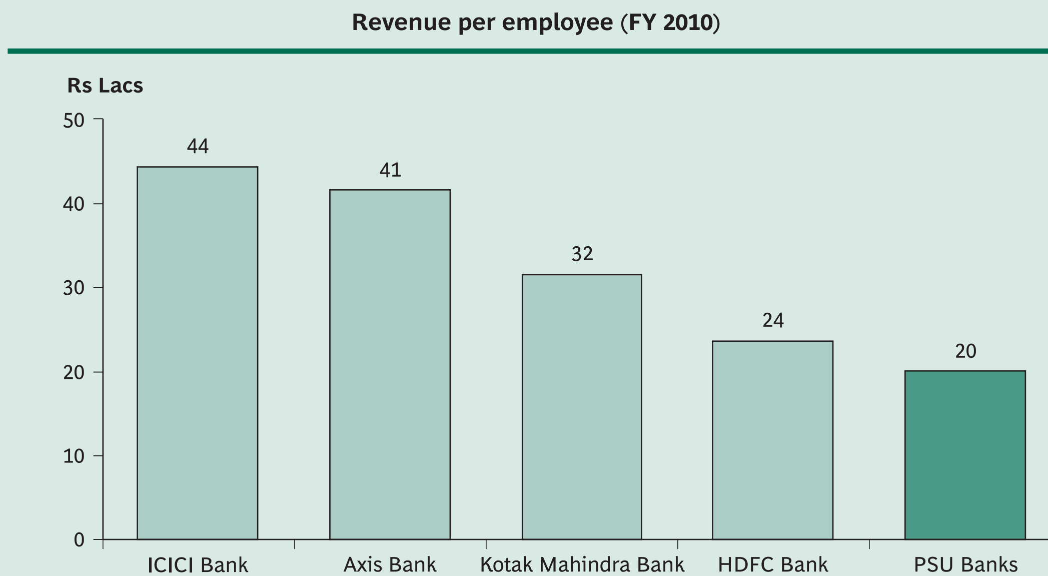
Source: IBA.

Exhibit 3e. Productivity of the public sector has doubled



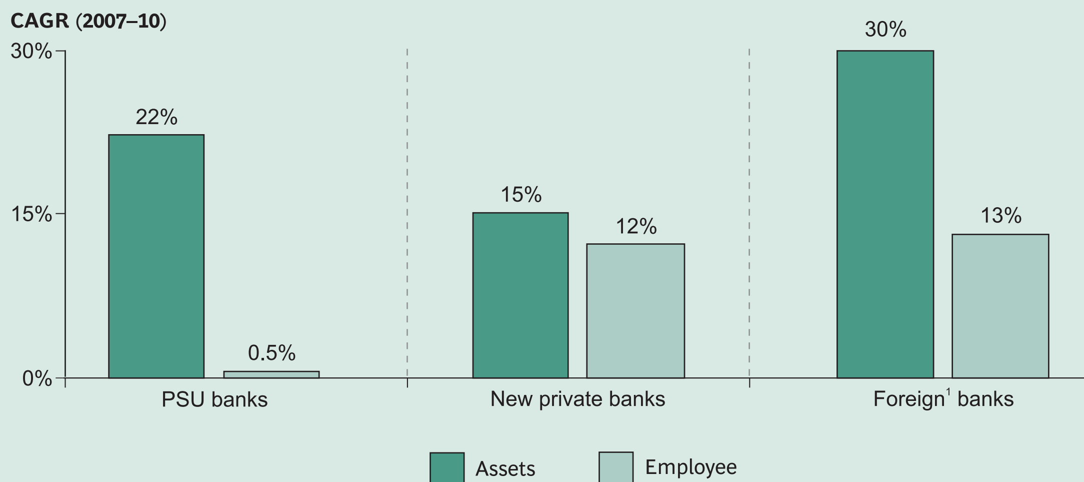
Sources: Capitaline; IBA; BCG analysis.

Exhibit 3f. Manpower productivity across banks — Public and private sector are comparable if outsourced head count is taken into account for the private sector



Sources: IBA; BCG analysis.

Exhibit 3g. Induction of talent at different rates — Talent induction within the public sector is unsustainable



Sources: Capitaline; IBA; BCG analysis.
[1]Data is for 2006–09.

For public sector banks, seeking growth by only enhancing the productivity of existing employees will yield diminishing returns. Exhibit 3g illustrates the unsustainable pattern of talent induction on which the public sector has been betting its future. When the growth rates of the total assets and the total employees of public sector, private sector and foreign banks over the last three years are compared, a critical imbalance is revealed. While in the private and foreign banks the growth in employees is in sync with the balance sheet, the public sector banks have increased their manpower by a meager growth rate of 0.5 percent to achieve a balance sheet growth rate of 22 percent.

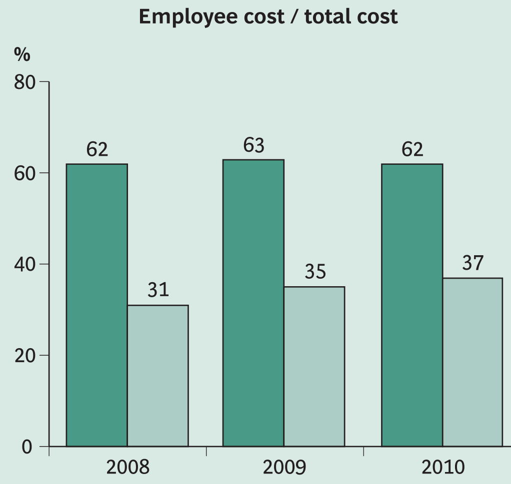
While the number of public sector employees has been growing slowly, the opposite is true for employee costs within the public sector. 2010 has been a watershed year. For the first time, the average cost per employee in the public sector has surpassed that of the private sector. As illustrated in Exhibit 3h, the average cost per employee within the public sector is Rs 5.6 lacs per annum, higher than the private sector average of Rs 5.3 lacs per annum. This is contrary to the popular perception that the public sector salaries are lower. The sector thus faces twin challenges — the need to induct talent in large numbers and the need to contain staff costs. The cost structure of the public sector banks varies significantly from that of the private sector. About 62 percent of the costs of the public sector banks comprise employee costs, as against 37 percent in the private sector. Globally, this ratio is about 50 percent for most banks. Employee costs which are fixed in nature, introduce operating leverage into the bank's profit and loss statement. A dip in the performance due to market conditions affects the bottom line directly. On the other hand, a cost structure with appropriate levels of outsourcing allows the bank to pass on some of the market risks to business partners. Similarly, variable components in employee costs are also linked to performance, which helps protect margins.

The final challenge relates to the need to learn new practices while "unlearning" long–standing practices that are no longer a best practice. The business model of the past was founded on a predominance of back–office skills. The new business model, enabled by new technology, requires that additional skills be devoted to sales and customer service. The existing manpower has to be re–skilled accordingly, as illustrated in Exhibit 3i.

Exhibit 3h. Public sector employee costs have to be managed

Starting 2010, average cost per employee of public sector is higher

Employee heavy cost structure means higher operating leverage

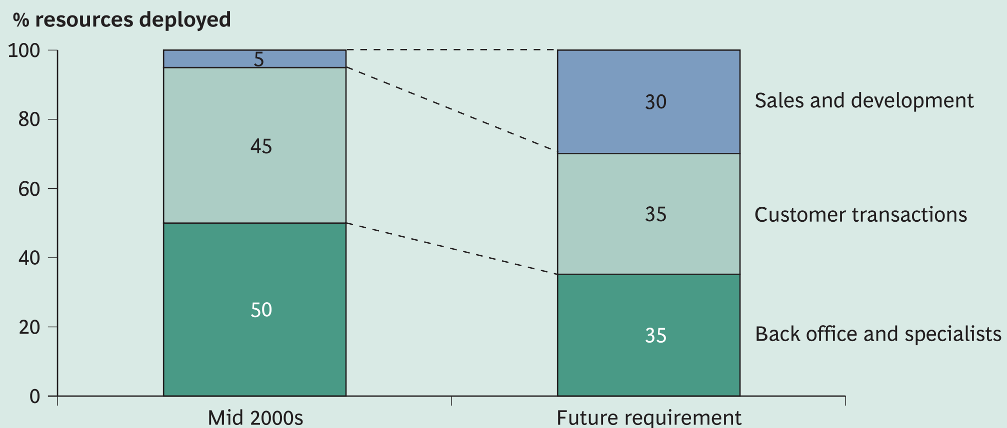


PSU banks New private banks

Sources: Capitaline; IBA; BCG analysis.

Exhibit 3i. Massive re–skilling is required in order to increase productivity of employees and enhance service quality

Expected change in distribution of roles



Best practice FO:BO ratio – 3:1

This massive, organization–wide skill realignment is only half the step. The bigger challenge is achieving the unlearning of underlying perceptions. The top talent in the public sector grew up learning the practices of the past. There is a sharp difference between the old and new paradigms, as shown in Exhibit 3j. The new principle of maximizing “Share of Wallet” has to replace the former principle of Maximum Permissible Bank Finance (MPBF) with its roots in credit allocation. Employees can only embrace the concept of quick turnaround time if the long–standing fear of undue haste is put to rest. People practices also have to contend with similar challenges. Today’s need to court young talent has to overcome the prevailing mindset that new recruits must earn their stripes before they are entitled to be courted. The developmental environment expected by new recruits with its foundations in frequent and honest performance feedback has to overcome the long–standing practice of confidential performance evaluations. This battle to fight perceptions and traditional practices is the biggest challenge in transforming the human resource framework in the public sector. Any intervention must explicitly take this reality into consideration.

A Balanced Intervention — Combining Discipline and Motivation Levers

Unwinding decades of legacy requires a concerted and determined effort. Public sector banks with their unique and complex position require a very careful orchestration of a series of initiatives that are built concurrently on performance discipline and staff motivation. BCG research and experience has shown that the journey from ‘low performance’ to ‘high performance’ is best managed by a sequence of steps that enhance discipline and motivation simultaneously. Exhibit 3k illustrates how public sector banks can deploy these two levers as part of a 3–5 year improvement program.

Discipline levers:

1. Steady talent induction:

As discussed above, public sector banks must induct manpower at a steady rate to support growth and make up for the rapidly retiring manpower. The rules of the game have changed since a decade ago, when large numbers were steadily recruited. Exhibit 3l illustrates the annual increase in head count of select large public sector banks. As one can see, the banks that do recruit, do so in

Exhibit 3j. Re–learning agenda — Lingering ideas inhibit the pace of change

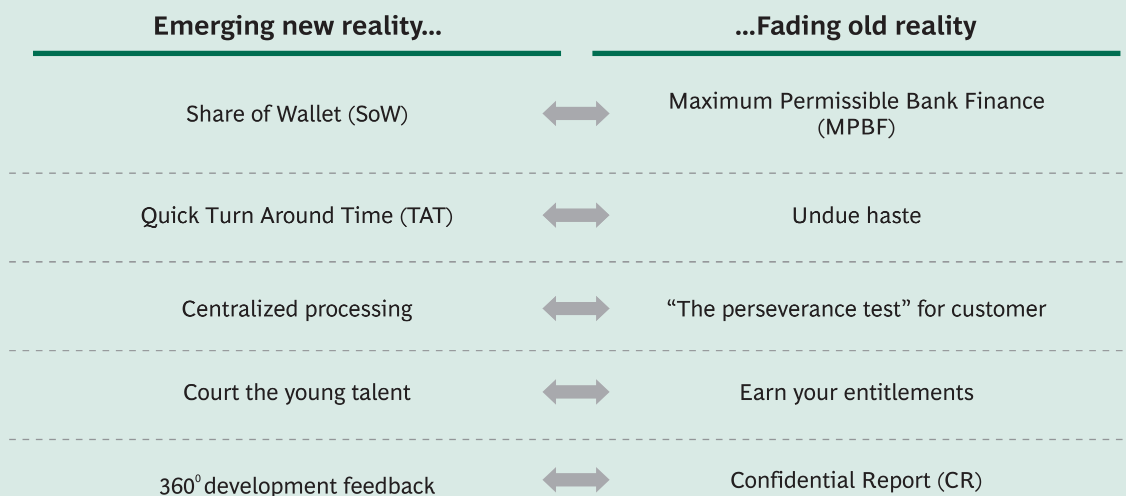


Exhibit 3k. A concerted plan needs to balance discipline and motivation — A Sustained 3–5 year planned program required

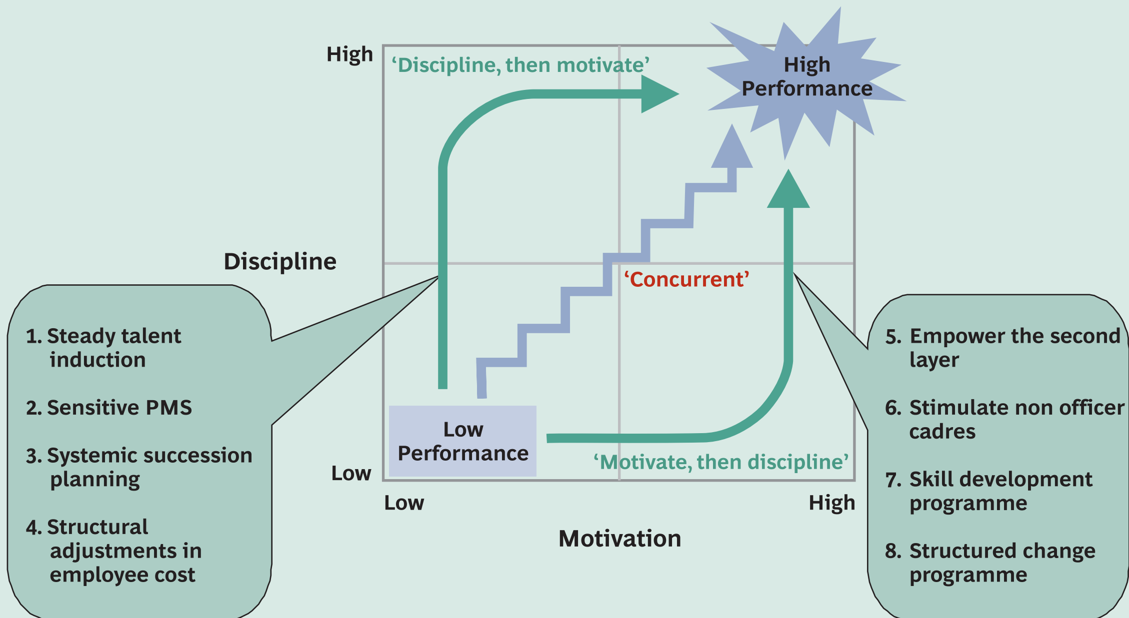
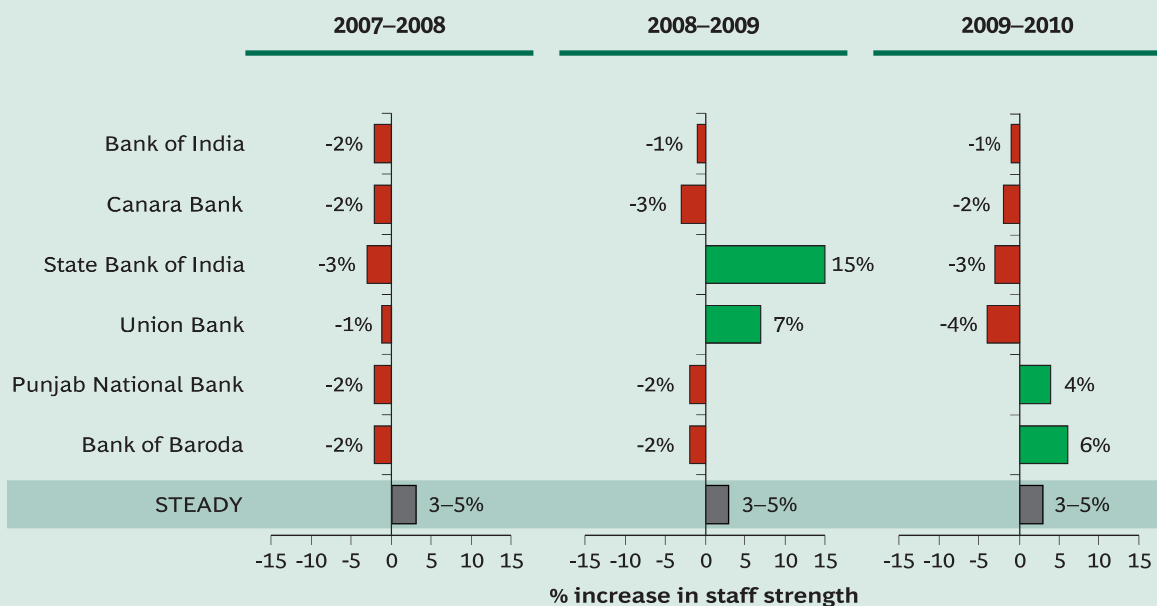


Exhibit 3l. Recruitment has to be steady



Sources: IBA; BCG analysis.

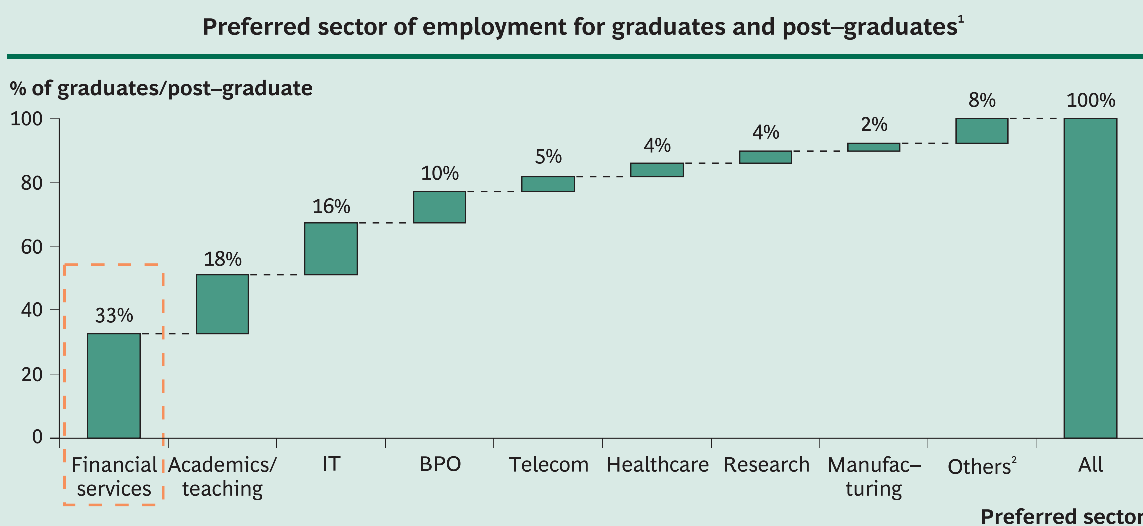
spurts. A sudden spike in head count in one year is followed by a lull in the next. What is needed is steady growth in head count to support consistent growth in business. This requires a carefully coordinated recruitment program that is attuned to the new rules of the recruitment market. The following initiatives should be considered:

- **Create an employee brand that appeals to young recruits:** Just as many public sector banks have re–branded themselves for young customers, so must they re–brand their corporate image in the recruitment market. In order to attract the required quality and number of new hires, the banks must first identify those recruiter pools that are a good match for their needs and those in which they are competitively advantaged. A study by BCG revealed that the public sector banks are a top employment option among graduates within Tier 2 and 3 towns, as illustrated in Exhibit 3m. Once the banks identify such pools of target recruits, they must gain a deeper understanding of what the candidates seek in a job in order to create an offer that is attractive to them. For example, it is critical to realize that many recruits are seeking a first job rather than a lifelong career. This will make a big difference in how the offer is packaged and communicated.

- **Induction and on–boarding:** As with customers, employees also tend to be loyal if they are on–boarded well. On–boarding ranges from the mundane details of administration to inspirational introduction to the institution's heritage and legacy. The experience is an integral part of the recruitment offer. Meticulously planned and executed cross–functional rotation, a mentorship program, training and skill development sessions and recognition of performance, all go into making a fruitful on–boarding experience for the first three years. If the bank can make an employee stay for three years, the probability of the employee leaving for a marginally higher compensation is significantly lower.

- **Project demographic risks — locate future skill gaps:** It is not sufficient to recruit fresh talent at an entry level. Rapid retirements over the next decade will lead to a disappearance of skill sets and know–how at senior levels of the organization. Such

Exhibit 3m. Financial services is the most preferred sector for graduates — Public sector banks among the top picks in smaller towns



Sources: BCG talent survey; BCG analysis.
[1]Response to question "Which sectors will you most prefer to seek employment in?" asked to graduates and unemployed respondents.
[2]Others includes construction, retail, travel & tourism, aviation and transport & logistics.

"Knowledge at Risk" can be located by identifying manpower requirements within different job families. This skills need projection has to be juxtaposed against the projections of supply of staff, net of retirement, in the same job families. Certain job families like credit and treasury sales are typically in deficit and need to be planned for at various levels.

- **Lateral / unconventional talent induction:** Several job families require talent on contract at senior levels at high salaries. Banks should consider direct induction at senior levels from unconventional talent pools. A state–owned telecom company recently utilized such an approach, directly recruiting at Deputy General Manager levels to make up for a shortfall at that level.

2. Sensitive Performance Management System (PMS):

An effective PMS is at the core of any modern high–performance–oriented organization. The PMS of many private sector institutions have evolved into highly sophisticated systems. They utilize balanced score cards that go beyond simple financial targets for performance. Some deploy a 360° feedback mechanism. Public sector banks are lagging far behind. Their performance management systems are typically rudimentary and lack credibility with appraisers and appraisees alike. As a result, promotions need to be done through interviews because there is insufficient documentation of the performance track record. Many public sector institutions are unable to fully distribute incentives because it is difficult to differentiate top performers from the rest. A PMS that is sensitive to the social context of public sector banks could be based on the following themes:

- **Conventional models of PMS will fail in the social context of PSU banks:** Certain preconditions for a successful conventional PMS system are typically absent in a public sector bank. First, the quality of power exercised by an appraiser on the appraise is poor. Research has shown that unless managers have a minimum critical number of 3–4 levers of power over their team members, they do not exercise powers. Second, a PMS is predicated on rich developmental feedback between the appraiser and the appraise. It requires a culture of trust, and a tradition of strong leadership training, both of which are typically absent in PSU banks. Third, the banks do not provide a social setting where differentiation is welcome. Personal performance reports are kept confidential, and, without transparency, there is no context for distinguishing average from outstanding performance. It is common for many employees to receive "outstanding" ratings, regardless of whether their performance in fact stands out from that of their peers. The concept of differentiation based on performance must first gain common acceptance before performance scores can conform to statistical distributions. A fourth issue that weakens the credibility of the PMS is the lack of any transparent linkage with promotions, postings or incentives. Finally, there are structural issues that kill any desire to perform. The accountability regime has singed many. Likewise, promotion is often tied to a painful transfer of location. Given the above five factors, any PMS scheme implemented in a public sector bank must be sensitive to these social constraints.

- **Fewer targets:** The first and the simplest place to begin with is to re–establish the sanctity and credibility of targets. The branch managers in many public sector banks have as many as 60 targets. With such a high number of targets, the manager stops taking ownership and responsibility. A system that tracks those 4–5 parameters of performance most relevant to the head office and that gives autonomy to people to perform within that umbrella needs to be devised. Further, the key result area for each job family has to be created in a manner that lends itself easy to measure along with sources of information that are available and identified. Targets have to be designed in such a manner that they are not susceptible to market risks and have the general acceptance of being stretched, yet realistic.

- **Incentive scheme — celebrate the average:** The current government sponsored incentive scheme is not achieving the desired results. The scheme envisages identification of the top 25 percent of staff, a distinction that can't be made within the existing PMS. But even if the current PMS did allow such differentiation, the incentive scheme would still be ineffective. Under the existing framework, the incentive is not a prize that an employee can achieve by working harder towards a defined, measurable target. Rather, it is a prize for winning a race against one's peers. The former model was more effective in getting people to work harder since the target was visible. Further, as highlighted earlier, not much is gained by celebrating only a few

top performers. This approach demoralizes the vast majority of staff — the average performers. In the cultural setting of the public sector banks, inclusive group incentives would be more effective. Finally, the incentive has to be linked over time to the PMS scores.

- **Making the wheels move:** The most difficult aspect of making the PMS work is to complete the tasks of target setting, performance evaluation, appraisals and feedback within a stipulated time frame. Even the most people–oriented organizations usually slip here. Significant energy from the relevant HR department and the CEO's personal commitment are crucial to defeat the inertia in target setting, measurement, evaluation and providing feedback — the difficult conversations that are so easy to avoid.

3. Systematic succession planning and career management:

The exit of experienced professionals in large numbers creates gaps that need to be tracked and filled with careful planning. The following ideas need to be considered:

- **Create career tracks:** While generalist officers have served the banks well, the evolving business context will require them to increasingly match aptitude with placement of staff. Bankers will need to specialize in different business lines while maintaining basic general competency. Corporate banking, retail banking, treasury, finance, technology, and HR will increasingly require staff with relevant aptitude. Banks need to identify 5–6 such tracks within which the staff can be groomed. While some staff would only move up vertically in their tracks, high–potential staff would be moved horizontally to groom them for general management positions.

- **Inventorize skills and competencies:** Banks have to create a skills and competency inventory covering most of the employees. Technology should be used to capture rich details to identify potential successors to critical positions and identify the most optimal placement for individuals.

- **Career forums:** In most public sector banks, career planning of individual officers is shrouded in mystery. At the time of promotions, the interview committee members seek informal recommendations to identify a list of deserving candidates. But the process is opaque, undermining its credibility. In order to capture richer information about officers and increase the credibility of the process, there must be a process in which each level of management holds collective developmental discussions about their direct reports. The career forums for senior executives should include members from top management, who would discuss performance, debate potential career paths, make recommendations for future trainings, placements, and assess readiness for promotions. At BCG, we believe that when the middle management debates the careers of their team members, the credibility of their own career management goes up. It enhances morale, makes the middle management feel empowered, and every one in the organization feels supported.

- **Use of technology to optimize placement:** Banks undertake the tumultuous task of transferring a large number of officers every year in line with service conditions. This is currently a manual exercise that attempts to find the most optimal solution, satisfying many constraints such as service rules, employee preference, business exigencies and so on. Given the enormity and complexity of the task, employee career planning and succession planning is often compromised for more urgent considerations. But banks no longer need to make such trade–offs. By leveraging technology, they can now identify with relative ease the optimal solution within a wide array of constraints, including policy, personal preference, career plan of the individual, succession planning for critical positions, recommendation of career forums, and business priorities.

4. Structural adjustments in employee costs:

Over time, public sector banks need to create operating leverage by reducing the high fixed employee costs that currently account for over 60 percent of total costs. As markets become more competitive, agility in cost structure is required to deal with the volatility in revenue streams. Intelligent outsourcing of non–core functions is almost mandatory to ensure that the cost to the bank is variable with business volume. An increase in compensation has to be structured on a variable basis such that higher employee costs are accompanied with higher revenues and vice versa.

Motivation levers:

5. Empower the second layer:

The single most important lever to recharge human resources in public sector banks is to unlock the potential of the second layer of management. This senior and middle management layer can make or break any new initiative or change program. Disengagement at this level stymies any new idea. Over time, real empowerment has reduced as technology has led to increased centralization of decisions. The excitement of the role has reduced. In our view, the HR transformation begins here. Exhibit 3n illustrates the four levers that the top management has to reflect upon to re–charge and re–engage the next layer fully.

- **Enrich the roles:** The first step is to begin by asking if the role is sufficiently exciting to motivate the executives. What additional responsibilities can make the role more enriching and challenging? In our experience, a limited span of control creates a tendency to micromanage, which negatively impacts the job satisfaction of both the supervisor and the team members. Most organization have not been redefined roles for decades, and an inquiry into the aspirations of executives at this level is long overdue.

- **Empower the executives:** A feeling of disempowerment at this level is the single biggest dampener of new initiatives. Over time, the executives at this level have stopped exercising their powers. Our research shows that executives do not exercise their power unless they have 3–4 credible levers of authority over their team members. Banks have to systematically study the levers of power and influence that the middle managers have and selectively introduce more levers to ensure that the critical mass is attained. The managers then need to be trained in how to leverage these new powers.

- **Enable the person:** The middle managers have to lead officers and the non officers below them to drive performance. However, they have not been explicitly trained in leadership skills. This can block the communication flow and stymie any change initiative. Banks need to prioritize leadership training for this level. As illustrated in Exhibit 3o, the high–potential performers at this level should be channeled into fast–track grooming programs to fill the vacancies within the top management positions. The program to nurture future leaders cannot use classroom training but rather

Exhibit 3n. Unleash the potential of senior and middle managers

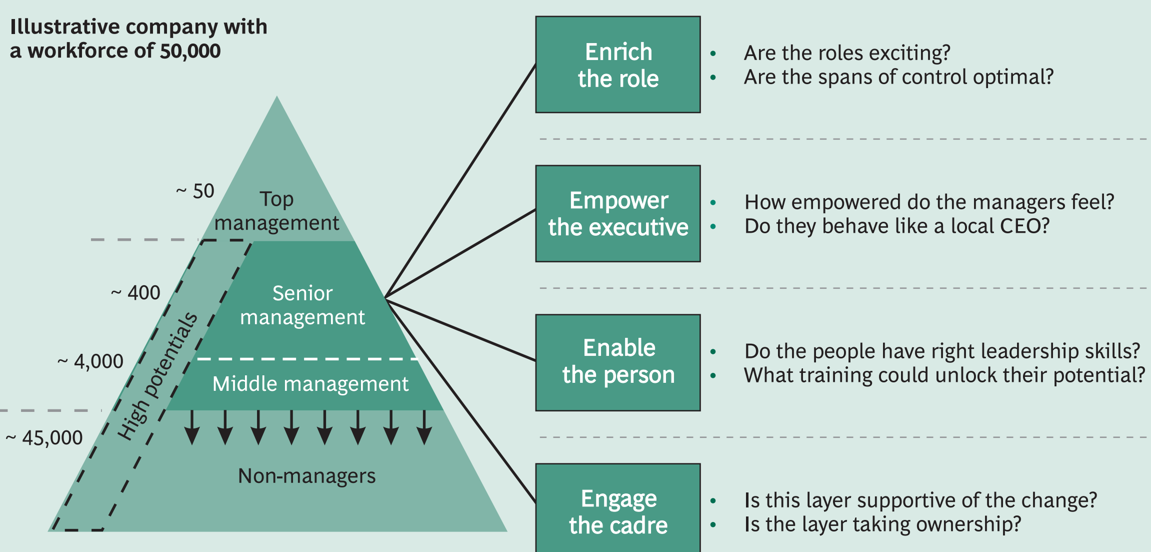
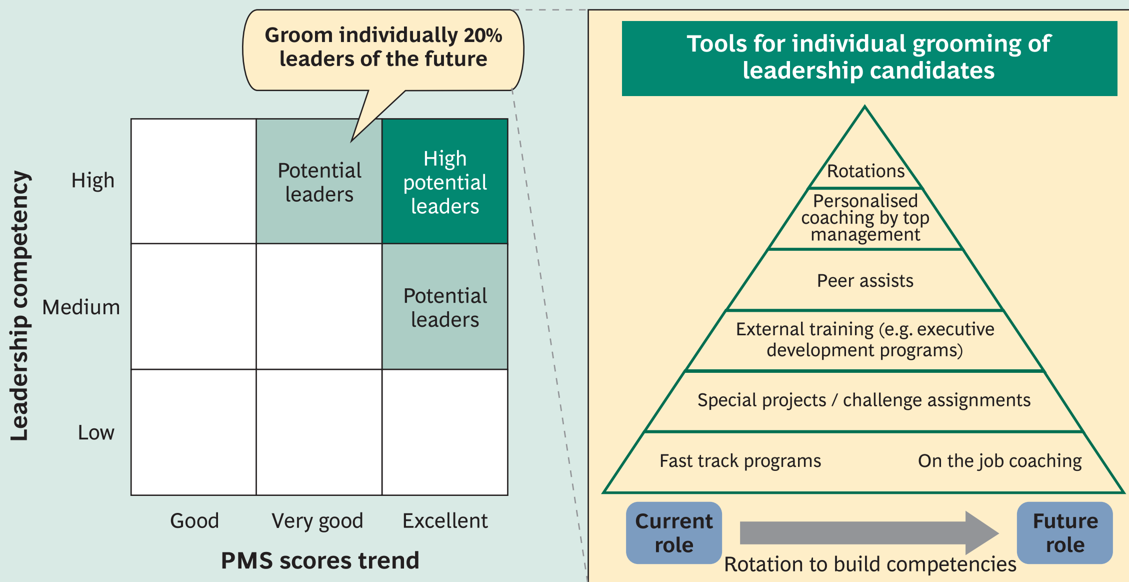


Exhibit 3o. Program to nurture "Leaders of the Future"



on–the–job learning, involving a variety of interventions such as special projects, personal coaching, peer assist programs, and a customized job rotation program.

- **Engage the cadre:** The first step in the HR transformation has to begin with engaging this level to create complete ownership. Communication to staff is most credible when it comes from their immediate superiors. The new way of managing talent in banks has to be explained to the staff by this level of management.

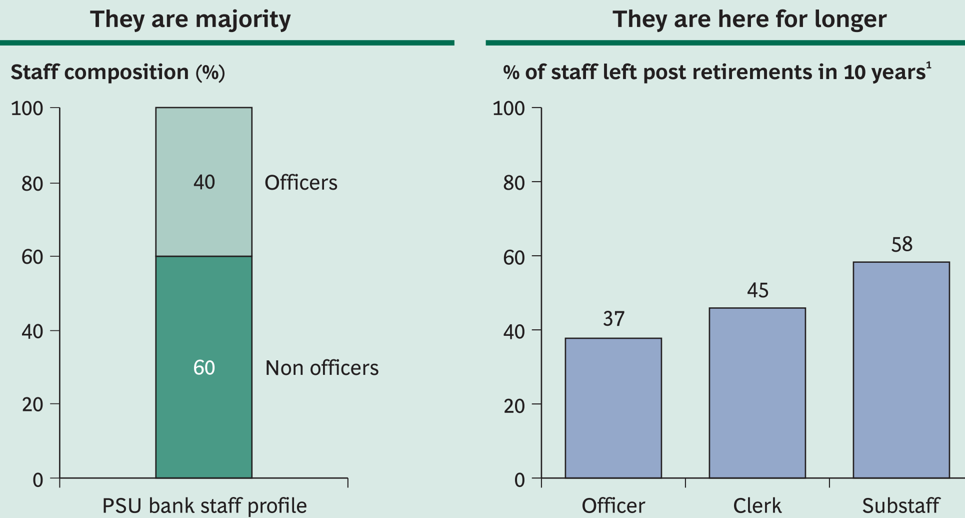
6. Stimulate non officer cadres:

Non officers constitute a majority of the staff within the public sector, representing almost 60 percent of the total workforce. Their significance is further amplified by their position as the first line of customer contact, literally the human face of their institutions. Add to this the non–officers' relative youth, and resulting potential for a longer–term stake in their institutions as illustrated in Exhibit 3p, and it becomes clear that they are integral to the long–term success of any HR transformation within the public sector. Over the next decade, no institution can ignore this segment and still achieve sustainable people advantage. Our experience suggests that the non–officer segment represents significant unharnessed potential within public sector banks in India. This is at least in part due to the pervasive myth that non–officers lack either the ability or the motivation to make a meaningful contribution to bank performance. On the contrary, those banks that employ simple campaign–specific incentive schemes for non officers find they are received with refreshing enthusiasm, yielding impressive results in areas such as third party sales. A dedicated unit in the HR department can effectively deploy programs throughout the year focused on key levers such as re–skilling, business campaigns, and incentives for non–officers.

7. Create a "Virtual University" for skill–set development:

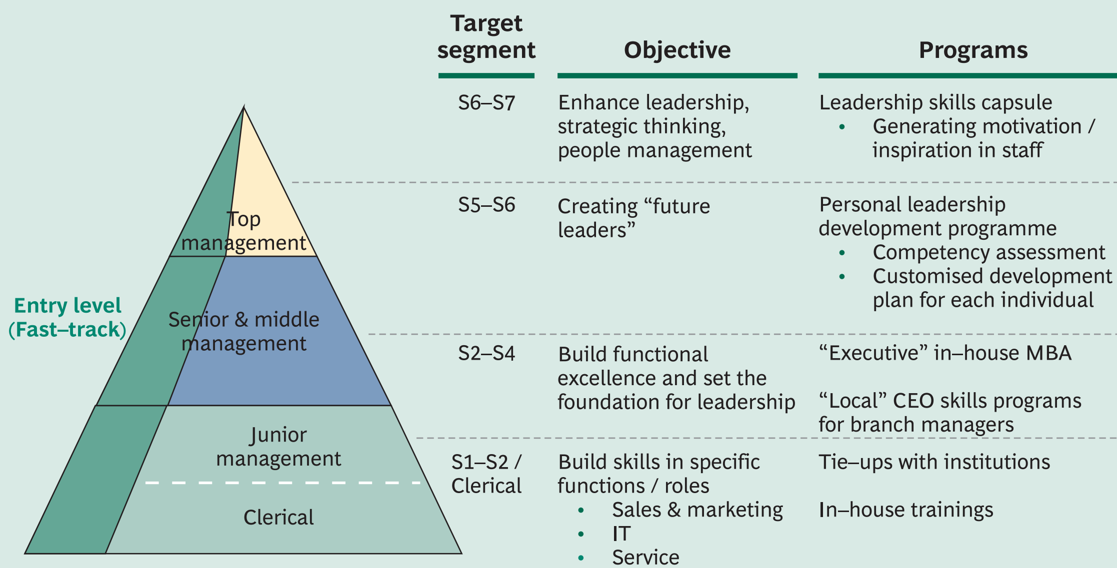
As previously highlighted, new skills are required at every level of public sector banks. Exhibit 3q illustrates the required skill development programs at each level. A dedicated "Virtual University" is essential to conduct and coordinate this mix of programs consistently and continuously. The programs at the lowest level are oriented towards new functional skills such as sales and

Exhibit 3p. Need to energize non officers



[1]One large public sector bank.

Exhibit 3q. Virtual Universities to manage skill development at all levels



Target segment	Objective	Programs
S6–S7	Enhance leadership, strategic thinking, people management	Leadership skills capsule • Generating motivation / inspiration in staff
S5–S6	Creating "future leaders"	Personal leadership development programme • Competency assessment • Customised development plan for each individual
S2–S4	Build functional excellence and set the foundation for leadership	"Executive" in–house MBA "Local" CEO skills programs for branch managers
S1–S2 / Clerical	Build skills in specific functions / roles • Sales & marketing • IT • Service	Tie–ups with institutions In–house trainings

marketing, services, technology and so on. For the branch managers, the focus is on business management expertise and a change in mindset essential to prepare them to assume the full range of responsibilities of a "local CEO". A bank's virtual university could offer certification, the equivalent of an in–house MBA degree. For senior managers, the challenge is to provide the leadership coaching that will prepare them for seamless transition to top management roles. The officials at the top management have to be sensitized on motivation and inspiration which is crucial to oversee the change. Some programs are purely internal. Others have to be conducted with external assistance. The most crucial ones are integrated into daily workflow.

8. Structured change management:

This is a complex change management exercise. HR issues are highly sensitive and require change at the most personal level. People need to change their daily behaviour and responses in different situations. Staff takes cues from the spoken and the unspoken word. The risk of demoralization from promises that aren't kept is very high. HR transformation should be attempted only when top management is fully committed to the change, has a clear vision of the desired result, have sufficient time to see the change through. The following ideas need to be considered to enhance change.

- **Top management perceptions:** The top management typically epitomizes the best of the old work context. The work context itself has to change for an HR transformation to be successful. The top management has to convince itself of the new principles for people development, creating a brand for the organization's employees, generation Y's aspirations and expectations from jobs, creating specialist tracks for people and so on. Most importantly, the top management has to identify ways to prevent genuine mistakes from destroying people's careers under an often insensitive accountability regime.

- **Strengthened HR department:** The size and shape of the HR department has to be fundamentally different. New units must be created to introduce concepts such as career management, performance management, non–officer engagement, and so on. The other existing departments have to be upgraded with new skills, technology and role mandates. Recruiting has to be beefed up to facilitate a steady inflow of talent and ensure effective on–boarding. The change must begin with the HR department.

Imperatives for the Government and Regulations

Banks and non banks alike need state support and positive regulatory encouragement to undertake initiatives highlighted here to address the challenges and help the nation actualize the promise of the decade. Various committees have highlighted a long list of policy initiatives. The recommended list below is not a comprehensive list but issues that emerge as most important and urgent from the analysis of issues put forth in this report.

1. Deepen Wholesale Debt Market with Top Priority

Many reports have highlighted the need and action points required to deepen India's wholesale debt market. Action agenda is complex because it treads across legislative, regulatory, and economic issues. It requires co–ordination across regulators. Perhaps that is why progress is slow. Vibrant wholesale debt markets will enable financial services industry assist India more wholesomely. NBFCs, who have to play a crucial role in various segments as discussed in Chapter 1, will not depend on bank finance for growth. Risks of NBFC business will not come on banking system balance sheets. Large corporate clients will access even cheaper capital. Banks will find reasons to focus on, often neglected, SME segment. Infrastructure finance from appropriate long term sources will ease ALM risk on banks' books.

2. Enhance Economic Viability of Financial Inclusion

While the primary responsibility is upon the banks to innovate and experiment, the government and the regulator can accelerate the evolution through interventions and encouragement.

- Transaction fee based models are crucial to create viability. It is important that short–sighted back–lash against economic pricing is appropriately guided to prevent the business models from being stunted from early days.
- Shared infrastructure will play a pivotal role in making the business models viable. Government can spur the creation of viable business models by nucleating the shared infrastructure (For example, a shared facility to host low value accounts) and subsidizing it to encourage participation.
- Ensure interoperability in BC network. Interoperability is crucial to unleashing network effects and enhancing the viability of distribution infrastructure in remote areas. Government and regulations have to encourage interoperability in the networks by incentivizing common standards, interfaces, and shared infrastructure that makes interoperability feasible.
- Government payments form a significant portion of the cash flows for some of the potential customers. The viability of the models would be enhanced if the government payouts were to be made through the banking channels for the unbanked. At least in the first few years, the government should consider paying a transaction fee to the banks who enlist the customers to whom state payments are being made.
- Collateral in form of land records is an invaluable asset for secured lending. Computerization of land records and easy accessibility and pledging of land

for secured lending can unlock significant funds and convenience for customers. The government should undertake such technological upgradation in land records on a mission mode.

3. Continued Emphasis to Revitalize Rural Co–operative Banking Institutions

Government is already spending over Rs 14,000 crore to revitalize rural co–operative institutions under the Vaidyanathan Committee Scheme (VC–I). This is a historic opportunity to once and for all pull co–operative banks out of dysfunction. Co–operative banks were highlighted in Exhibit 2a as a channel that serves genuinely low ticket business. It has the reach, local flavour, and cost structure that commercial banks do not have. The growth of co–operative bank channel has got stymied due to ineffective governance framework which has resulted in poor capabilities and technology. The Vaidyanathan Committee (VC–I) recommendations are being implemented to revitalize the important channel. Central government has to prevail upon the states to adopt the model legislation for co–operative banks in spirit and conduct elections. NABARD has to introduce technology and skills into these banks much beyond what VC–I has envisaged.

4. Enable NABARD to Play Pivotal Role in Rural Infrastructure Development

Financial inclusion alone is not sufficient to drive inclusive economic growth. Economic activity in the local area (especially rural) has to be given fillip through concurrent multi disciplinary interventions embedded around core infrastructure development projects. The interventions vary with each area depending on its economic potential but include a range of initiatives like capacity building, agricultural extension, watershed development, etc. Here market failures abound. Commercial viability is rarely assured. We need development financial assistance.

We have an institutional gap here. There are multiple state sponsored financial institutions that are involved in rural infrastructure financing but none with sufficient breadth of expertise, depth in balance sheet, and backing from government. NABARD comes closest to an ideal institution for this purpose given its range of expertise, heritage in development financing and collaborative operating model. NABARD is the conduit for channeling RIDF funds to states. But they are hardly enough. NABARD needs to be enabled as pivotal institution for rural infrastructure financing and development.

5. Spur HR Transformation in Public Sector Banks

While the PSB themselves needs to start a concerted program to recharge their HR (as described in Chapter 3), the government needs to create supportive environment to accelerate the change.

- Movement towards variable performance linked salaries has to be expedited. To begin with government sponsored incentive scheme should be modified such that emphasis from "Top 25% Performers" is removed and predictability of rewards established. Banks with better overall performance need to be allowed higher levels of incentive distribution. Over time, the extent of incentive distribution needs to be a purely board decision.

- In the short term, PSBs need to be encouraged to bridge capability deficits at various levels through lateral induction at market rates, limited period contractual or consulting engagements.

- Compensation at senior levels has to be gradually moved closer to market to attract and retain talent. To begin with this could be achieved with variable bank performance linked component to prevent strain on bank financials. Over time, the level of compensation has to be a board decision.

- Homogeneity in HR framework across all PSB has to give way differentiation in HR policies by different PSBs over time. Better ones will attract better latent. Successful innovative practices by one bank will lead to emulation by others. A bit of competition between banks on this count will help engender creativity in solving the problem. Over time, Government has to relent from being the sole custodian of the HR policies and manage the banks purely towards defined and measurable financial and non financial objectives.

Note to the Reader

About the Authors

Bharat Poddar, Pranay Mehrotra and Ruchin Goyal are Principals in BCG's Mumbai office. Alpesh Shah and Saurabh Tripathi are Partner & Directors in BCG's Mumbai office. Ashish Garg and Neeraj Aggarwal are Partner & Directors in BCG's Delhi office.

For Further Contact

If you would like to discuss the themes and content of this report, please contact:

Alpesh Shah
BCG Mumbai
+91 22 6749 7049
shah.alpesh@bcg.com

Ashish Garg
BCG New Delhi
+91 124 459 7076
garg.ashish@bcg.com

Neeraj Aggarwal
BCG New Delhi
+91 124 459 7401
aggarwal.neeraj@bcg.com

Saurabh Tripathi
BCG Mumbai
+91 22 6749 7015
tripathi.saurabh@bcg.com

Acknowledgments

This report has been prepared by The Boston Consulting Group. The authors would like to thank IBA and FICCI for conducting surveys within member banks and the corporates respectively. The analysis of the survey has been included in this report. The authors also gratefully acknowledge the contributions of Abhishek Garg, Chanchal Bansal, David Nazareth, Khushnuma Dordi, Parth Krishna, Prabhpal Grewal, Rakshitaa Maheshbabu, Rishab Goel, Shaveen Garg and Yashraj Erande in conducting various analyses for this report. A special thanks to Payal Sheth for managing the production process and Jamshed Daruwalla for his enthusiastic editing and designing support.

For Further Reading

The Boston Consulting Group has published other reports on this topic which may be of interest to senior management. Recent examples include:

Equity Mutual Funds: Charting your Course with a Compass
A report by The Boston Consulting Group, June 2010.

Global Wealth Management: Regaining Lost Ground — Resurgent Markets and New Opportunities
A report by The Boston Consulting Group, June 2010.

Retail Banking: Winning Strategies and Business Models Revisited
A White Paper by The Boston Consulting Group, January 2010.

Global Payments: Weathering the Storm
A report by The Boston Consulting Group, March 2009.

Corporate Banking: Thriving in the New Normal
A report by The Boston Consulting Group, December 2008.

Value Creation in Indian Banking: Tale of Business Model Discount
A report by The Boston Consulting Group, July 2008.

The Next Billion Consumers: A Road Map for Expanding Financial Inclusion in India
A report by The Boston Consulting Group, November 2007.

The Next Billion Banking Consumers
An OFA by The Boston Consulting Group, June 2007.

For a complete list of BCG publications and information about how to obtain copies, please visit our Web site at www.bcg.com/publications.

To receive future publications in electronic form about this topic or others, please visit our subscription Web site at www.bcg.com/subscribe.

09/10

BCG
The Boston Consulting Group

FICCI
Federation of India Chambers of Commerce and Industry

Printer: Spine text instructions

1. Align top of “Title” with the cap height of the monogram “BCG” on the front cover

2. Align bottom of the BCG logo (The Boston Consulting Group) with the baseline of the BCG logo at the bottom of the front cover

3. Title and Logo should match cap heights—adjust both to fit width of spine

Indian Banking 2020: Making the Decade’s Promise Come True

The Boston Consulting Group