McKinsey Global Institute

Accelerating India's Growth through Financial System Reform

May 2006

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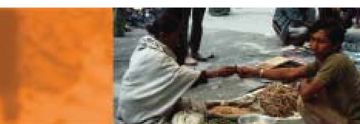

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Preface

Accelerating India's Growth through Financial System Reform is the result of a six-month research project by the McKinsey Global Institute, in collaboration with our McKinsey offices in India. This research builds on MGI's previous work on global capital markets and on our proprietary database of the financial assets of more than 100 countries, and it draws on the unique perspectives of our colleagues who have worked extensively with financial institutions in India and around the world.

Susan Lund, a senior fellow at the McKinsey Global Institute based in Washington, DC, worked closely with me to provide leadership on this project. The project team also included Ezra Greenberg, an MGI fellow; Jaeson Rosenfeld, an MGI senior consultant and McKinsey alumnus; Raj Doshi, a McKinsey consultant; and Fabrice Morin, an MGI fellow.

We have benefited enormously from input received from Leo Puri, leader of McKinsey's financial institutions practice for India; and Tilman Ehrbeck, Joydeep Sengupta, and Naveen Tahilyani, all principals in McKinsey's India office who have worked extensively with financial institutions. In addition, we would like to thank Suman K. Bery, director general of the National Council of Applied Economic Research; Anand P. Gupta, director of the Economic Management Institute in New Delhi; Ravi Narain, CEO of the National Stock Exchange; Ajay Shah, consultant to the Ministry of Finance; Susan Thomas, an assistant professor at the Indira Gandhi Institute of Development Research; and Mahesh Vyas, CEO of the Centre for Monitoring Indian Economy.

We also benefited from the extensive and thoughtful input received from our Academic Advisory Board members. Our board included Martin Baily, senior adviser to MGI, senior fellow at the Institute for International Economics, and formerly chief economic adviser to President Clinton; Richard Cooper, professor of international economics at Harvard University; Nicholas Lardy, a senior fellow at the Institute for International Economics; and Kenneth Rogoff, professor of economics and public policy at Harvard University and former chief economist at the International Monetary Fund.

Essential research support was provided by Tim Beacom, a senior analyst at MGI, along with Nishith Jardosh, an analyst in the McKinsey Knowledge Center in India. Gina Campbell, MGI's senior editor, provided thoughtful input and editorial support. Rebeca Robboy, MGI's external relations manager; Deadra Henderson, MGI's practice administrator; and Terry Gatto, our executive assistant, supported the effort throughout.

Our aspiration is to provide a fact base to policy makers and business leaders in India and around the world so they can make more informed and better decisions. As with all MGI projects, this work is independent and has not been commissioned or sponsored in any way by any business, government, or other institution.

Diana Farrell
Director, McKinsey Global Institute

May 2006
San Francisco

Executive Summary

India is becoming a major force in the world economy. Real GDP growth has averaged 7 percent over the past three years, and service and manufacturing exports are booming. India's equity markets have reflected these successes, tripling in value since 2003. As India develops, it will need an increasingly strong financial system—over and above a thriving equity market—in order to sustain or exceed its current rate of growth.

Our research shows, however, that on several dimensions India's financial system falls short. The system intermediates only half of the country's total savings and investment, and it channels the majority of funding to the least productive parts of the economy. Indian banks lend a much smaller fraction of deposits than banks in other countries, and the value of India's corporate bond market amounts to just 2 percent of GDP. Moreover, much of the financial system operates inefficiently.

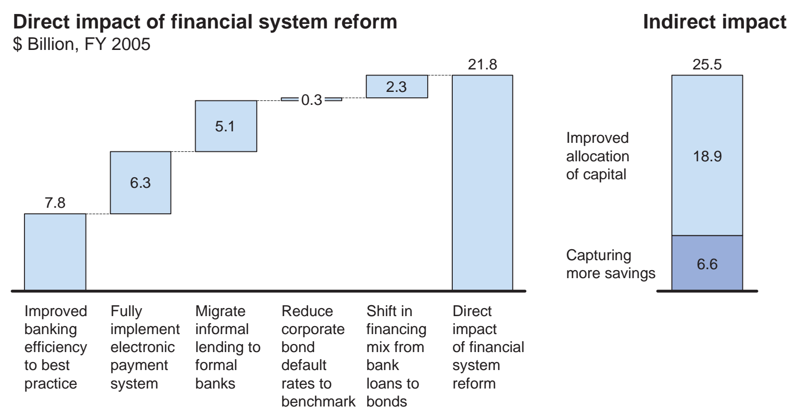
These shortcomings impose a heavy cost on India's economy. But by the same token, reforms would yield very large benefits. We calculate that an integrated program of financial system reforms could free up $48 billion of capital per year, equivalent to 7 percent of GDP (Exhibit 1). Even more important, these reforms would raise real GDP growth to 9.4 percent a year. This would increase household incomes 30 percent above current projections by 2014, lifting millions more households out of poverty.

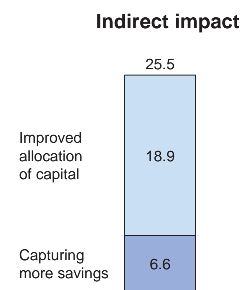
To capture this opportunity, India has to reduce the role of government in its financial system. Today, the government maintains many restrictions on banks and other financial intermediaries that limit competition, lower their performance, and serve to channel the majority of funding to the government

and its priority investments. Reforms to lessen government influence would result in more efficient use of savings and faster growth. That would raise tax revenues, allowing the government to spend directly on welfare programs, rather than diverting resources from the financial system and so holding back growth.

Exhibit 1

FINANCIAL SYSTEM REFORMS ARE WORTH $48 BILLION ANNUALLY





	Improved banking efficiency to best practice	Fully implement electronic payment system	Migrate informal lending to formal banks	Reduce corporate bond default rates to benchmark	Shift in financing mix from bank loans to bonds	Direct impact of financial system reform	Indirect impact
Percent of GDP	1.1	0.9	0.7	0.1	0.3	3.2	3.5

Source: RBI; CSO; McKinsey Global Institute Analysis

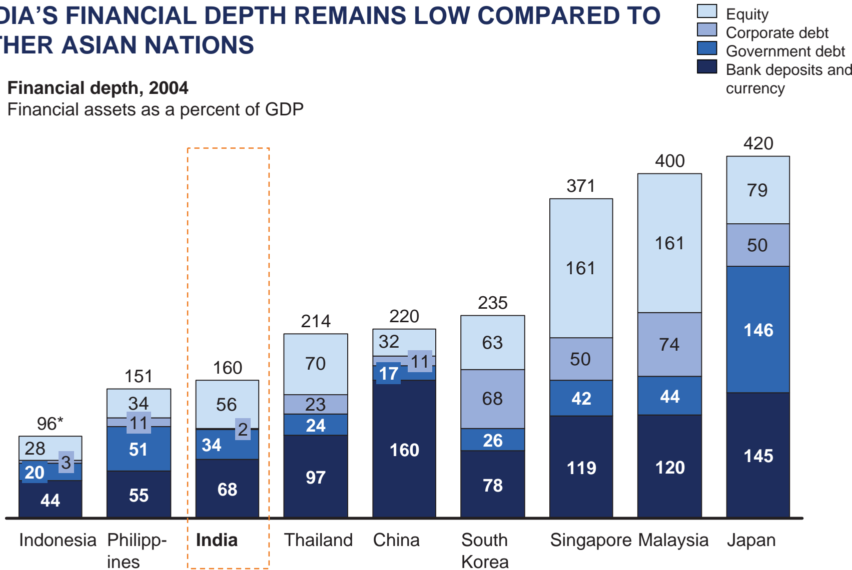
The financial system is small relative to the size of the economy

Despite India's 130-year-old stock market and long history of private banks, its financial system today intermediates a surprisingly small amount of assets relative to the size of the economy. This is shown by India's "financial depth," or the value of financial assets relative to GDP, which is significantly lower than in other fast-growing Asian countries (Exhibit 2).

Indeed, much of the savings and investment fueling India's GDP growth goes on outside India's formal financial system. Indian households save 28 percent of their disposable income, a very high rate. But they invest just half of their savings into bank deposits and other financial assets. They invest another 30 percent in housing and put the remainder—which amounted to $24 billion last year—into machinery and equipment for the 44 million tiny household enterprises that, along with agriculture, make up India's "unorganized sector."

Exhibit 2

INDIA'S FINANCIAL DEPTH REMAINS LOW COMPARED TO OTHER ASIAN NATIONS



Note : Numbers may not add due to rounding
Source: McKinsey Global Institute Global Financial Stock Database; team analysis

As a result, Indian households' share of physical investment in the economy has risen to a surprising 42 percent even though, with a few exceptions, household businesses are subscale, lack technology and business know-how, and have low levels of productivity. In 2005, Indian households also bought $10.3 billion of gold, arguably another form of nonfinancial savings, making them the world's largest gold consumers.

India's economy would grow faster if the financial system captured more of the country's savings and then channeled them to larger-scale, more productive enterprises. We calculate that reforms that enabled India's financial system to capture just half of the household savings now used for gold purchases and subscale household enterprise investments and channel them more productively could add $7 billion each year to GDP.

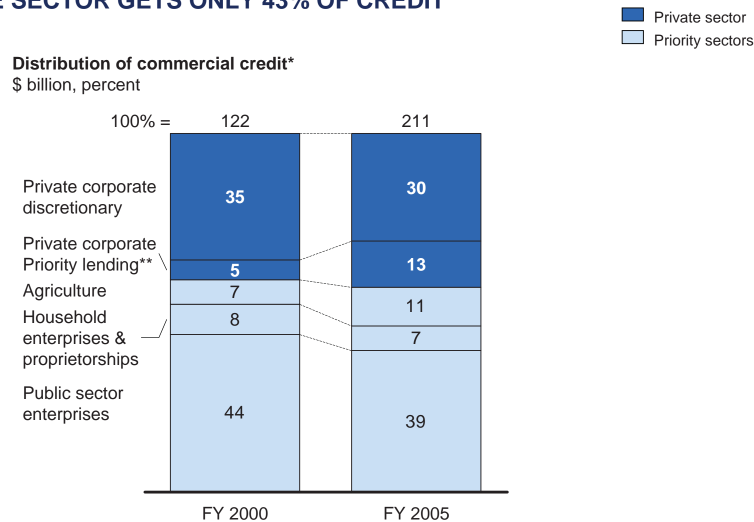
Majority of funding goes to the least productive parts of the economy

India's financial system channels only a minority of the savings it does capture to the most productive parts of the economy. India has a dynamic private corporate sector that has produced some world-class firms, especially in R&D, IT, and business-process outsourcing. But rather than fostering India's entrepreneurs, the financial system channels the majority of funding to the government and its priority investments.

India's private corporations receive just 43 percent of total credit[1] —a level that has not changed much since 1999 (Exhibit 3).[2] The remaining 57 percent of credit goes to state-owned enterprises, agriculture, and tiny businesses in the unorganized sector. This pattern of capital allocation impedes growth because state-owned enterprises have only half the private corporate sector's level of labor productivity and require twice as much investment to get the same additional output, while productivity in agriculture and the unorganized sector is one-tenth as high. India's equity market does a somewhat better job at funding the private sector: private company shares represent 70 percent of market capitalization. But new equity issues amount to just 2 percent of all corporate funding in India. Not surprisingly, Indian companies rely on retained earnings, which account for nearly 80 percent of the funds they raise, a far higher level than is seen in other Asian economies.

Exhibit 3

PRIVATE SECTOR GETS ONLY 43% OF CREDIT



* Gross bank credit excluding financial companies; Includes corporate bonds and private placements, loans and investments from the government to public sector enterprises.
** Estimate of lending to small corporations equals "other" priority sector lending outside of agriculture and SSI
Source: CSO; RBI; MGI; Public Enterprise Survey

1 Includes gross bank credit to nonfinancial companies, corporate bonds and private placements, and loans and investments from the government to public sector enterprises.

2 The main change that has occurred since 1999 is that the share of discretionary lending to the private sector has declined while the share of directed lending to small and medium enterprises in the private sector has expanded. This is the result of changes in the government's definition of "priority lending" to include companies such as small software developers and retailers, most of which the banks would lend to anyway.

Reforms that enabled the financial system to channel a larger portion of funding to private companies would raise productivity in the economy. State-owned firms and household enterprises would need to improve their operations to compete successfully for funding. Accompanied by continued reforms to India's labor and product markets, this would raise the productivity level of the whole economy over time and allow India to get more output for each rupee invested. We calculate that the resulting boost to GDP would be worth up to $19 billion a year.

Government's dominant role in the financial system explains poor allocation of capital

The government's tight control of India's financial system largely explains its poor allocation of capital. Regulations on banks and other intermediaries serve to channel funding directly to the government and to its priority investments, allowing the public sector to absorb much of the country's savings.

Banks are obliged to hold 25 percent of their assets in government bonds—and in practice the state-owned banks that dominate the banking sector hold even more.[3] Government policies then require banks to direct 36 percent of their loans to agriculture, household businesses, and other "priority" sectors. But such directed loans have higher default rates than other loans and are more costly to administer, due to their small size. As well as diverting credit from the more productive private sector, this policy lowers lending overall, because banks must expand unprofitable directed lending in proportion with their discretionary lending. Not surprisingly, Indian bank loans amounted to just 61 percent of deposits in March 2005[4], one of the lowest levels in the world (Exhibit 4).

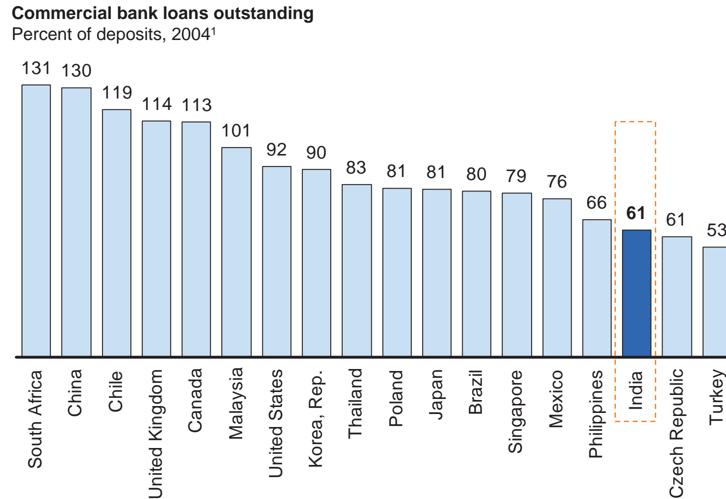
Similar policies have resulted in 90 percent of the assets of provident funds (essentially pension funds) and 50 percent of life insurance assets being held in government bonds and related securities. Without these rules, pension funds, mutual funds, and insurance companies would be an important source of demand for corporate bonds and equities in India, as they are in other countries. Such measures have stifled the development of domestic financial intermediaries: just 13 percent of workers in India's "organized sector" (mainly large companies and the government) have pension coverage.

3 Until recently, bond yields were falling and prices were rising, giving banks a profit on holding them.

4 Credit growth was 25% in the fiscal year ending March 2006. Data on deposit growth over the same period is not available.

Exhibit 4

INDIAN BANKS LEND A SMALL PORTION OF DEPOSITS



1 India as of March, 2005

Source: RBI; EIU; McKinsey Global Institute analysis

The government maintains these controls on the financial system to ensure that funds flow to state-owned enterprises and to the rural economy, and also to fund a persistently large budget deficit. Although the central government reported a modest operating deficit of 2.4 percent of GDP in 2004, this is only the tip of the iceberg. Including the deficit on the government's capital budget and the deficits of states brings the total government deficit to 11 percent of GDP in 2004—a level that has persisted over the past 25 years, despite large variations in the macroeconomic environment over that time.

Operating inefficiencies raise financial system costs

The government's influence on India's financial system also lowers its efficiency and raises the cost of financial intermediation. We calculate that reforms that addressed these inefficiencies would save nearly $22 billion a year.

In the banking sector, India has the highest level of state ownership of banks of any major economy today, apart from China—and even China is now seeking foreign investment in most of its major commercial banks. Although India has several high-performing new private banks, together these banks have only 9 percent market share. Foreign banks account for another 5 percent of deposits but cannot expand because of restrictions on foreign investment in the sector.

The dominance of state-owned banks reduces competition and lowers pressure on banks to improve their operations. They meet their costs by maintaining very high margins between lending and deposit rates: bank margins are 6.3 percent in India, compared to an average of 3.1 percent for South Korea, Malaysia, Singapore, and the United States.

Banks also lack competition from India's corporate bond market: its value amounts to just 2 percent of GDP. The market remains rudimentary because of the mass of regulations that unnecessarily raise issuance costs, lengthen listing procedures, and increase disclosure requirements. To avoid these hassles, Indian companies look for funding elsewhere. Some turn to private placements of debt, which total $44 billion—more than ten times the amount of publicly traded bonds. The largest companies also issue international bonds. India's underdeveloped corporate bond market forces large companies to seek funding from banks, which in turn crowds out lending to banks' natural customers, smaller companies and consumers. If India were to develop a vibrant corporate bond market and move to the mix of bonds and bank loans seen in other emerging economies, its companies would enjoy substantially lower funding costs. Banks in turn, would shift their focus to smaller businesses and consumers.

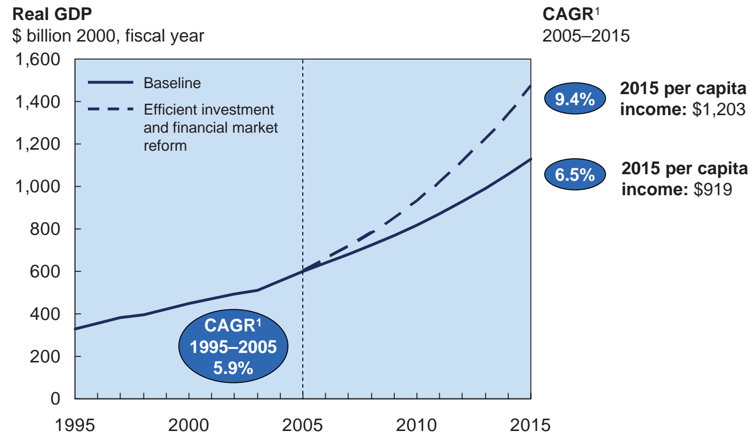
Even India's roaring equity market is constrained by heavy regulation elsewhere in the financial sector. India's equity market would perform even better if domestic financial intermediaries, with their long-term mind-set, and keen eye on corporate performance held more shares. But these intermediaries are at present required to invest in government bonds. Instead, corporate insiders own half of all shares, a situation with several drawbacks. Retail investors own only 17 percent of shares, but account for 85 percent of trading, suggesting they view the market as a gambling opportunity rather than a source of steady, long-term gains.

An integrated program of reforms could boost real GDP growth to 9.4 percent a year

An integrated program of financial system reforms can substantially raise India's growth rate. By improving capital allocation and raising the efficiency of investment in the economy, and by capturing more savings and reducing inefficiencies in the financial system, we calculate that India could grow real GDP at 9.4 percent a year, instead of the current forecast rate of 6.5 percent (Exhibit 5). By 2014, this would boost per capita income to more than $1,200, or 30 percent higher than it would otherwise have been.

Exhibit 5

MORE EFFICIENT INVESTMENT AND FINANCIAL MARKET REFORMS CAN BOOST INDIA'S GROWTH RATE TO 9.4 PERCENT



1 Compound annual growth rate.
Source: CSO; RBI; Oxford Economics; McKinsey Global Institute analysis

To achieve this, the government must loosen its grip on the financial system and allow financial institutions and intermediaries to respond to market signals. This means lifting directed lending policies and restrictions on the asset holdings of banks and other intermediaries to release more capital for more productive investment in the Indian economy. It also means reducing state ownership in the banking sector, developing a corporate bond market, and easing the many regulations holding back the development of pensions, mutual funds, and insurance companies. These reforms will boost competition in India's financial system, raise its efficiency, and improve its allocation of capital. They will also enable intermediaries to create more attractive consumer financial products, which will draw a larger share of household savings into the financial system, thereby increasing total investment in the economy. Together with broader liberalization throughout the economy, financial system reforms will increase productivity and unleash growth.

India's regulators have understandably resisted such reforms because of the risks of the transition: abandoning directed lending could raise rural unemployment, while releasing captive demand for government bonds could sharply increase government borrowing costs. However, the enormous potential

benefits of financial system reforms can greatly mitigate these risks. Expanding the productive sector of the economy is, over time, the best way to increase the number of well-paid jobs and lift more people out of poverty. It is the way other countries have succeeded in developing their economies. As important, the additional GDP will increase government tax revenues significantly, even without a rise in tax rates. This will allow India to pursue its important welfare objectives directly through social programs rather than by diverting resources from the financial system and hindering India's growth.

This report includes a detailed discussion of the analyses and conclusions highlighted here. It is organized into six chapters: 1. Introduction; 2. Benchmarking the performance of India's financial system; 3. Effect of financial system performance on India's economy; 4. Potential gains from financial system reform; 5. Priorities for the reform agenda; 6. Closing remarks.

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