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Being Five Star in Productivity

Roadmap for Excellence in Indian Banking

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Saurabh Tripathi

Bharat Poddar

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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 Centre,
Cuffe Parade
Mumbai – 400 005
India

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Executive Summary

We release this report in the midst of global uncertainty: S&P has downgraded the US credit rating and most of the Western world and Japan face a debt crisis. Central bankers throughout the world face an unprecedented situation. In the midst of the economic maelstrom, India stands out as a relative oasis of stability. Prudent regulatory oversight from RBI over the last decade has successfully steered Indian banks towards robust health and performance. This report highlights tremendous scope for Indian banks to improve their productivity from this strong base. Indian banks can be a benchmark in the world in productivity excellence and consequently in profitability.

Productivity excellence, however, is not merely an opportunity for higher value creation, but it is an obligation for Indian banks. Global banking crisis has highlighted the criticality of banks behaving responsibly; aligning to priorities of the real economy. For India to achieve its vision of rapid and inclusive growth, Indian banks have an obligation to serve the vast number of unbanked masses, under–banked farmers, and MSMEs. In order to do so at low cost and reasonable margins banks have to push the frontier on every dimension of productivity. Productivity increase can counter the short term pressures on profitability from rising interest rates, rising bad debts, and imminent savings bank rate deregulation.

This report sets out an action agenda based on insights from an extensive productivity benchmarking conducted across 40 banks in India coupled with project experience of The Boston Consulting Group (BCG) in India and abroad. The report argues that banks have to strive for excellence on five dimensions — branch sales and service, new channels, lean operations, organization design, and bad debt management. In each area, industry looks very sound at an overall level but disaggregation of performance into components and comparison across players exposes a lot of room for improvement.

Branches can generate higher levels of revenue for the banks. There is as much as 5X difference between the best and the worst bank in each category in terms of business generation per branch. Indian banks deploy 62 percent of staff in customer facing roles as against the benchmark of 82 percent observed by BCG globally. Banks can increase the effective time of branch staff for sales and service through empowerment of branch managers, role redefinition of staff, redesign of branch format, process reengineering, and simplifying their product portfolio. Public sector seems to be holding itself from proper investment advisory to retail customers. This can be a costly mistake.

Break out growth in usage of new channels will characterize the next decade in Indian banking. Among the new channels, mobile phones, propelled by 3G and smart phone technology, will emerge as an undisputed winner by 2020; potentially accounting for 20–30 percent of total transactions. ATMs have seen exponential growth in usage but are far from maturity with just about 50 percent adoption even in metros. There is as much as 5X difference in ATM usage across banks. Banks investing ahead of the curve will emerge winners in this next wave of retail banking. They need to begin with investing in adoption. New channels will not only enhance the productivity but can be a source of new customer acquisition. RBI has to encourage and not just permit experimentation for the full potential in mobile technology to play out.

On efficiency, Indian banks are doing well overall with industry cost–income ratio below 50 percent. However, the survey highlighted room for improvement. On an average, Indian banks have about 20 percent of staff deployed in back–office processing (for some banks, as high as 40 percent) as against a global best of 10 percent observed by BCG. Over two thirds of this processing happens in branches and not back office centres, where it should be. Back–office centres are smaller and sub–scale on an average. Process re–engineering and operating model change can help reduce costs, improve service, and contain operating risks. Public sector appears to be under–investing in technology with spends at about 25 percent of global benchmarks. It needs a new post–CBS IT strategy and a new procurement framework that encourages speedy investment decisions.

Indian banks average administrative overheads (head office, etc) at about 11 percent of total staff is in line with what BCG has observed globally. Some banks with 14–15 percent overheads need to investigate further. Cutting across bank categories, the industry appears to be holding low head count in HR and finance roles. Economizing on HR and finance capabilities may hurt the long term health of the organizations. Variable pay at 2 percent of fixed compensation is significantly below the 12–15 percent that is found optimal for incentive compensation. Long overdue, the public sector urgently needs an adjustment in its compensation structure.

Whilst the industry, on an average, has an impressive bad debt performance, the bad debt levels in priority sectors of MSME and agriculture are high. NPA management processes at banks need major overhaul. Speed of response to default and speed of foreclosure are found to be slower than required. Some banks have alarmingly high NPA levels in relatively safe products like home loans. The report has highlighted a whole new paradigm for risk management encompassing operating model, technology, experience and expertise retention, and minimum critical size of book.

Should the banks embrace the above ideas, they can break the compromise between profitability and serving low ticket, high risk business at reasonable margins. At the same time, government and RBI have enabling and catalyzing roles to play.

Government, at an industry wide level, should expedite real sector reforms to enable banks to manage bad debt better. Speed of decisions in debt recovery tribunals, quality and transparency of land records and property titles need to be enhanced, and real estate sector regulation needs to be introduced.

Government should introduce performance linked compensation framework for PSU banks wherein 12–15 percent of the salary could be variable for at least 75 percent of staff. It needs to create an enabling environment where procurement decisions for technology investment by PSU banks can be taken faster. It also needs to push for higher levels of risk management capability building in PSU banks through variety of measures highlighted in this report. Smaller PSU banks lag in business model transformation and government needs to spur the smaller banks to transform faster.

Initiatives from RBI are required on multiple fronts. It should define a new paradigm in risk management for Indian banks — going beyond Basel 3 — emphasizing ex–ante risk detection, management, expertise and experience retention. A centre for excellence in risk management should be sponsored by RBI to act as a research body and senior management training facility. It should insist on rapid roll out of Aadhar based credit bureaus in retail, MSME and agriculture.

RBI should take a proactive approach on technology led transformation. Benefits from adoption of mobile are so large that they merit a proactive regulatory approach that encourages experimentation by players. RBI should enable banks to adopt business models with a very low cost, local manpower in drop down subsidiaries to make low cost inclusive banking viable. Lastly, introduction of productivity metrics in mandatory reporting by banks will bring it on centre stage of industry agenda.

Productivity Excellence
An Obligation

"We are made wise not by the recollection of our past but by the responsibility of our future"

— George Bernard Shaw

Obligation of Indian Banks: Stay Healthy; Be Leaner

The Reserve Bank of India (RBI) has been widely acclaimed for steering Indian banks clear of the crisis that engulfed so many countries. Our analysis shows that such acclaim is well–deserved and, in fact, there is reason for more of it. Having moved the needle on almost all performance metrics in the last decade, the Indian banking industry stands out for its relatively robust balance sheet and sound performance. As shown in Exhibit 1a, Indian banks' profitability leans towards the higher end of the spectrum while its cost–to–income ratio leans towards the lower end. In addition, bad debt charged to P&L remains moderate and valuation is sound. On the quality and soundness of the financial services sector, India has edge over other emerging markets.

Sound performance is complemented by rapid growth that supports India's GDP expansion. At the current rate, the Indian banking industry will be the world's third–largest by 2025, as shown in Exhibit 1b. This increasing

Exhibit 1a. Indian banking: Sound health and balanced performance

Return on equity (%)

Country	Return on equity
Turkey	19.6%
Indonesia	17.8%
Malaysia	17.4%
China	16.7%
India	15.3%
Singapore	14.6%
Australia	14.0%
Canada	12.4%
South Korea	10.1%
Spain	8.2%
Russia	7.9%
Thailand	6.9%
France	4.0%
USA	2.7%
Germany	–0.8%

Cost: Income ratio (%)

Country	Cost to income ratio
Indonesia	79.3%
Germany	75.1%
France	73.1%
Canada	65.7%
USA	65.4%
Russia	59.4%
Thailand	56.7%
Australia	55.6%
Malaysia	54.6%
India	47.3%
South Korea	46.5%
Spain	42.1%
Turkey	41.9%
China	40.4%
Singapore	40.1%

Valuation (P–BV)

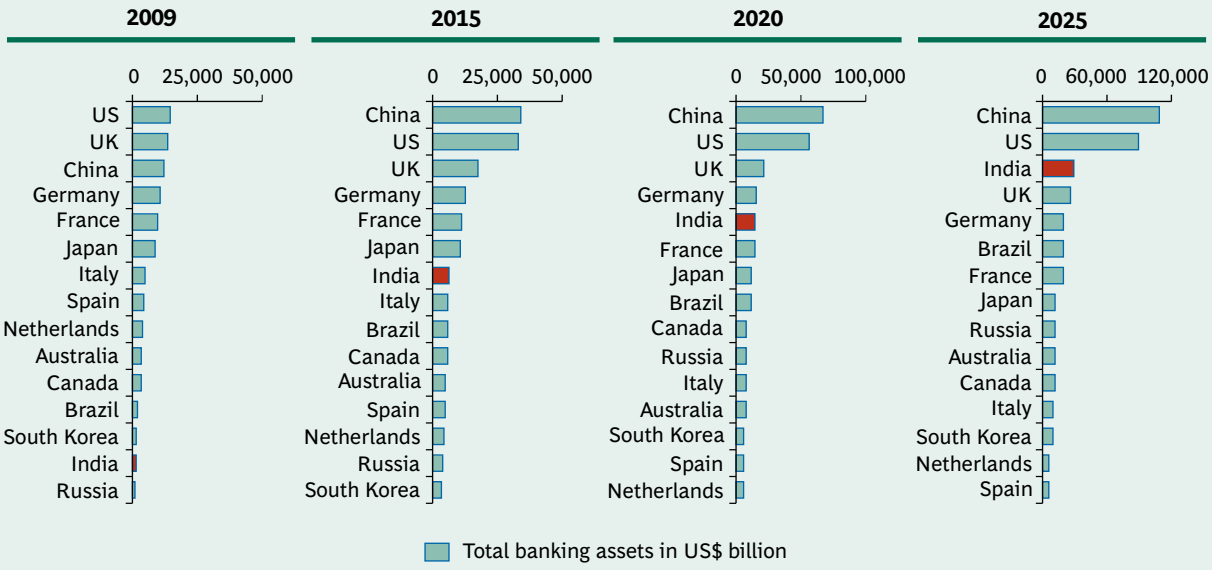
Country	Price / book ratio
Indonesia	3.6
Malaysia	2.3
Canada	2.0
Russia	2.0
Thailand	1.9
India	1.8
China	1.7
Australia	1.6
Turkey	1.5
Singapore	1.4
South Korea	0.9
USA	0.8
Spain	0.8
France	0.5
Germany	0.3

Bad debt[1] to assets ratio

Country	Bad debt to assets ratio
Russia	2.4%
Indonesia	2.0%
Turkey	1.3%
USA	1.2%
China	0.9%
Spain	0.7%
South Korea	0.6%
India	0.6%
Singapore	0.5%
Thailand	0.4%
Malaysia	0.4%
Germany	0.4%
Australia	0.4%
Canada	0.3%
France	0.2%

Sources: OECD; IBA data; Turkish Banking Association; Central Banks of Malaysia, Singapore, Thailand and Indonesia; Thomson Reuters Datastream; BCG analysis.
Note: Weighted averages over the years 2007 to 2009. Indian data for a year corresponds to year ending in March (e.g. April 2009 to March 2010 corresponds to year 2009). For other countries the data corresponds to the calendar years. The valuation data is for the calendar year 2010.
[1]The bad debt charged to P&L as a percentage of assets.

Exhibit 1b. Indian Banking will be worlds 3rd largest by 2025



Sources: EIU country data; OECD; IBA data; BCG analysis.

significance and influence comes with a higher level of responsibility towards the real economy. The global banking crisis has highlighted the perils of irresponsible banking, with the real economy footing the bill for banks' folly. To discharge their responsibility towards the real economy, banks have an obligation to stay healthy, to adopt balanced and profitable growth, and to strive for higher levels of efficiency and productivity in every aspect of their operations.

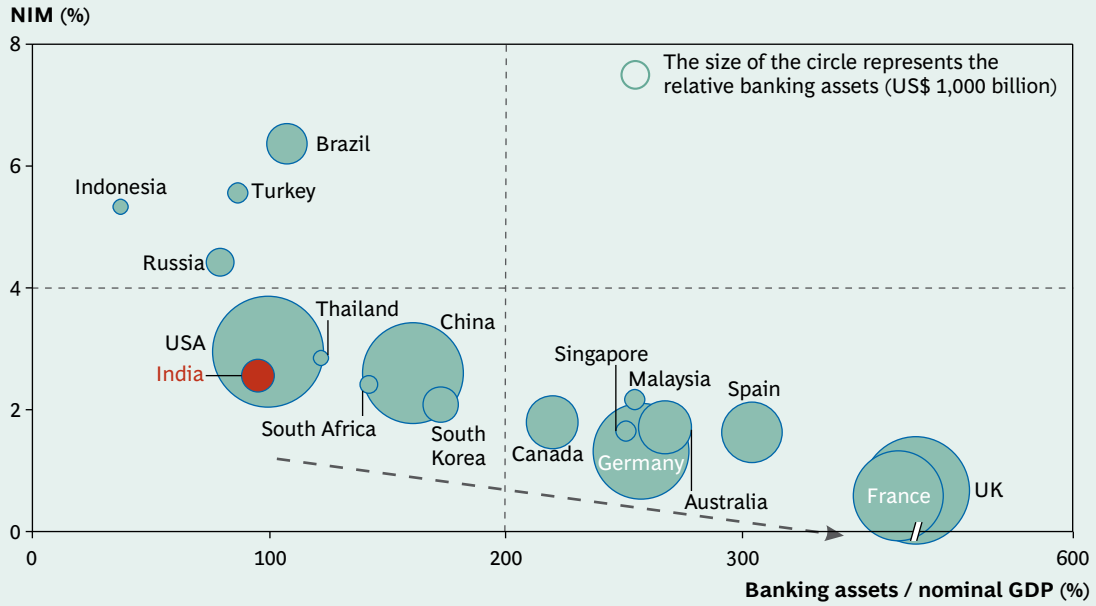
The obligation of Indian banks, in particular, goes one level beyond staying healthy. The appalling level of financial exclusion is a blot on an otherwise commendable performance of the industry. High operating costs in serving low–ticket businesses has been the primary barrier inhibiting initiatives — state–sponsored or market–driven — from making any progress. Banks have a responsibility to innovate and create new models of business that operate at sufficiently low operating costs. Indian banks are obligated to be leaner and more productive.

Excellence in productivity will help the banks break the compromise between maintaining their profitability at reasonable interest margins and serving high cost, high risk customers that are on national priority.

Bank Margins in India: Too High or Quite Low?

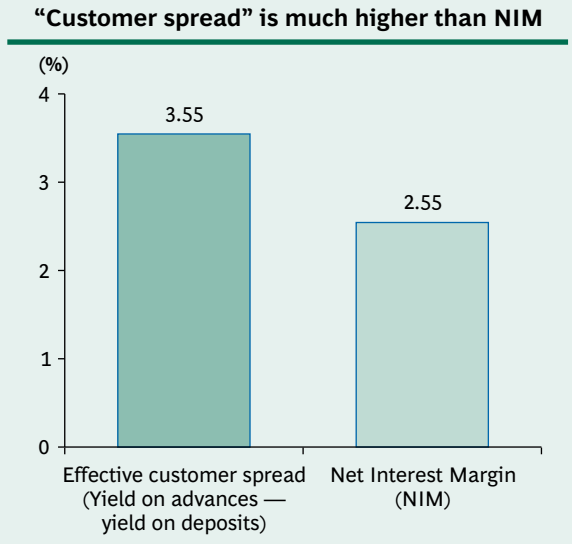
The debate on the obligation of the banking sector to the real economy often focuses on the cost of intermediation or the Net Interest Margins (NIMs) of the banking industry. The classical argument is that banks should strive to lower their NIMs and thus benefit their borrowers and depositors. The NIM of the Indian banking industry is about 2.5 percent. Looking at how comparable economies have evolved, this margin is expected to hit about 2 percent by 2020 as banks' assets hit the benchmark of 200 percent of nominal GDP (from about 90 percent at present). As is clear from the Exhibit 1c, the Indian banking industry's NIMs are comfortably in the middle of the spectrum and nowhere near as high as in countries such as Indonesia, Brazil, Russia, and Turkey. Is this a matter of satisfaction? That is not clear. First, the effective customer spread, defined as the difference between the interest charged to borrowers and interest offered to depositors, is almost one percent higher than

Exhibit 1c. Evolution of NIM with expansion in banking



Sources: EIU country data; OECD; IBA data; Turkish Banking Association; Central Banks of Malaysia, Singapore, Thailand and Indonesia; BCG analysis.
Note: Indian data corresponds to year ending in March 2010. For all other countries the data corresponds to the calendar year 2009.

Exhibit 1d. SLR stipulation leads to underrepresentation of Indian NIM



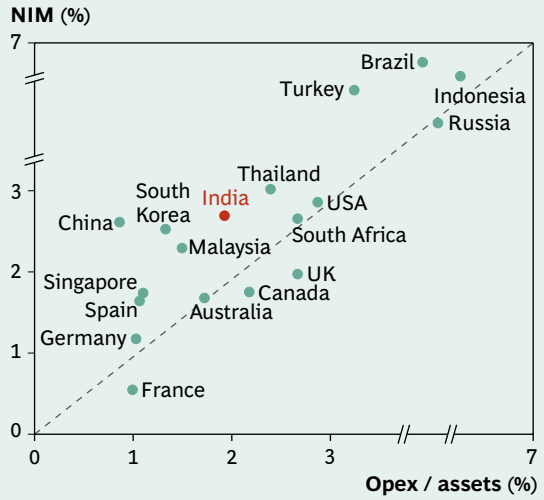
Sources: IBA data; BCG analysis.
Note: Data for FY 10.

NIM because of the Statutory Liquidity Ratio (SLR) stipulation as shown in Exhibit 1d. So NIMs are not a fair representation of the cost of disintermediation borne by the customers.

More importantly, there is a crucial irony in this debate. The performance metrics which the industry (and the regulator) aspires to improve encourage banks to avoid precisely the businesses that the regulator (and the nation) wants them to do. Priority sector businesses like small–ticket rural advances, high–risk Micro, Small and Medium Enterprises (MSME), agricultural lending to small farmers, and low–ticket deposits for financial inclusion are all high–risk, high–operating cost, and, hence, high–margin business. If the industry did more for the priority sector, its cost to income ratio will be higher, bad debt cost will be higher, and margins will have to be higher. For an emerging economy like India with inclusiveness as a national priority, it is not clear whether low banking margin is in itself a worthy goal.

Exhibit 1e shows that bank systems with lower opex tend to operate at lower margins. This report argues that it will be more effective for the government, regulator, and

Exhibit 1e. Bank systems with lower opex tend to operate at lower NIMs



Sources: OECD data; IBA data; Austin Bank – Brazil; Turkish Banking Association; Central Banks of Malaysia, Singapore, Thailand and Indonesia; BCG analysis.
Note: Weighted averages over the years 2005 to 2009. Indian data for a year corresponds to year ending in March (e.g. April 2009 to March 2010 corresponds to year 2009). For other countries the data corresponds to the calendar years.

the industry to set high aspirations on composite metrics of productivity. Such composite metrics have to encompass human resources, technology, bad debt costs, and customer service. Productivity excellence breaks the compromise between undertaking businesses that are a national priority and operating at reasonable margins at the same time. For the Indian banking industry, this is an obligation to the nation.

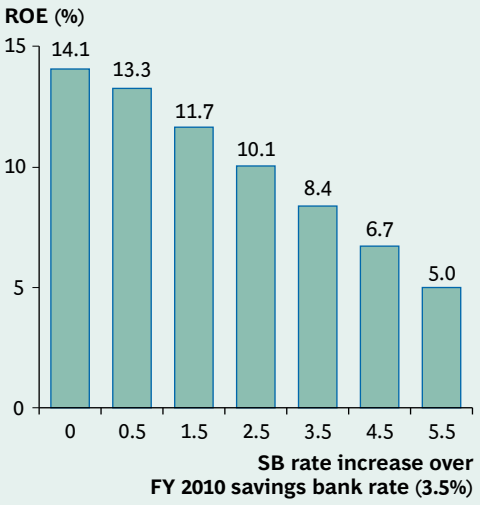
Productivity Excellence: Need of the Hour

Beyond the strategic rationale for productivity excellence articulated above, there are tactical reasons why productivity excellence should be on top of any bank CEO's agenda.

- The emerging regulatory framework post–crisis will require banks to keep higher levels of capital in future. To deliver the same ROE on higher levels of equity, banks will have to be able to generate higher profits from the same assets. Higher productivity in sales, service, operations, and bad debt management will be crucial in achieving this.
- Rising interest rates imply a pressure on bank profits due to Mark–to–Market (MTM) losses on investment book. Productivity enhancement could compensate for such loss of profitability and help sustain a steady ROE.
- The specter of economic slowdown in India always looms large in the background. A rise in NPAs is inevitable in such an environment and some uptick is already being seen in NPA levels. Effective bad debt management is crucial to maintaining profitability in such a scenario.
- Improving the efficacy of the regulatory transmission mechanism is crucial for the RBI in its fight against inflation. As such, a discussion paper has been put out on the possibility of deregulating the Savings Bank (SB) interest rate. It is widely expected that once deregulated, SB interest rate will go up because of competition. Exhibit 1f depicts the potential impact of SB rate increases on the ROE of banks. For every 1 percent increase in SB rate that cannot be passed onto the customers, the ROE of banks will fall by 1.65 percent. Given the low credit off–take and a rising

Exhibit 1f. SB rate deregulation will necessitate productivity enhancement

Every 1% SB rate hike (not passed to borrowers) will reduce bank ROE by ~1.65% on average



Sources: IBA data; BCG analysis.
Note: Data for FY 10.

interest rate scenario, it is highly likely that passing on interest rate increases to the customers will not be fully possible. In that case, the industry has to brace itself with productivity enhancing measures to counter the effect of higher SB rates.

Being Five Star in Productivity: Beyond Traditional Notions

Banks have to embrace a composite notion of excellence in productivity as shown in Exhibit 1g. This composite notion goes beyond the traditional shop floor notion of manpower productivity and has to cut across the silos of sales, service, back office, collections, and head office. Our study shows that Indian banks have to strive for excellence in the following five areas:

1. Branch sales and service excellence
2. New channel excellence
3. Lean operations and operating model
4. High–performance organization
5. Bad debt management: proactive, pre–emptive, and preventive

The rest of this report is structured along these five areas of excellence, as illustrated in Exhibit 1h with one chapter dedicated to each. Each chapter highlights the current status of Indian banks in the relevant area, compares Indian industry with international benchmarks where applicable, and highlights a broad roadmap toward excellence that banks can pursue.

Excellence in each area earns the bank a "Star" and those banks who master each of the 5 distinct areas of productivity will deserve to be called the "Five Star" banks in the industry.

The FIBAC survey analysis has revealed significant difference between banks on a host of metrics relevant to each of these five dimensions. Clearly, different banks have achieved excellence in different areas. Banks need to evaluate where they stand in each dimension and chart out an action plan to achieve "Five Star" status.

A composite notion of bank productivity

Exhibit 1g. Bank profitability driver tree

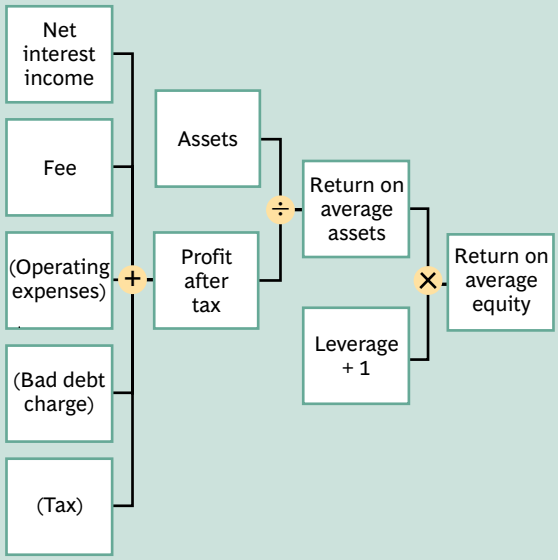
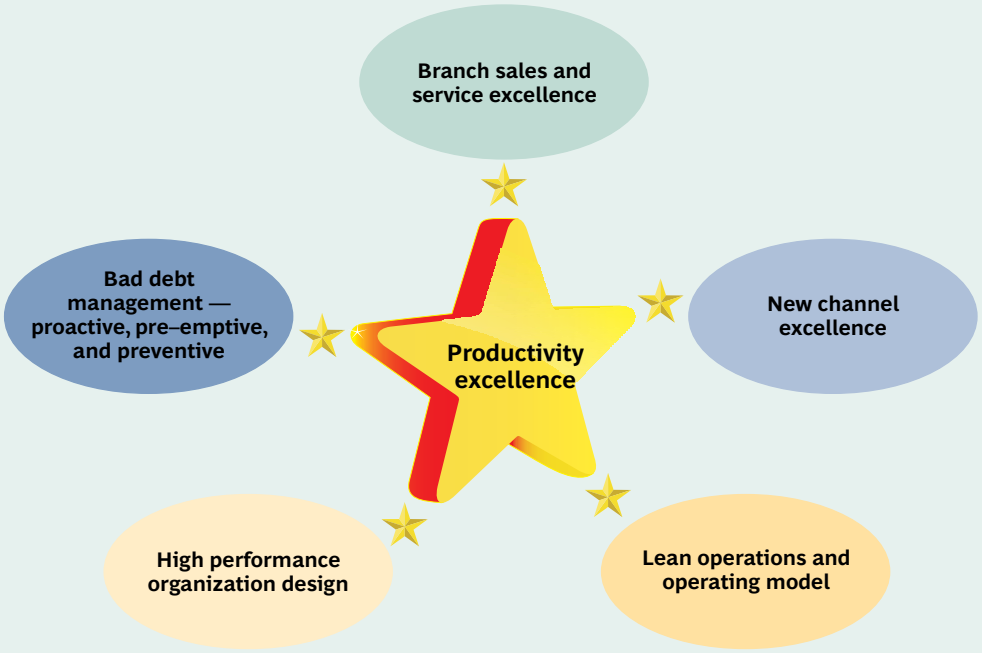


Exhibit 1g lays out the simple driver tree that illustrates the linkage of various levers to the ultimate goal of Return on Equity (ROE) for the bank. Net Interest Income (NII) and fee income add up to form total revenue of the bank, which, net of Operating Expenses (Opex), bad debt charge, and tax, leads to the Profit After Tax (PAT) for the bank. PAT per unit of asset leads to Return on Assets (ROA). A bank's ROE is (leverage + 1) times its ROA. For this study, the impact of leverage has not been detailed. This is partly because leverage in Indian banks is largely controlled by regulations. Some banks that maintain high leverage do so for extraneous reasons that are not relevant to a discussion on bank productivity.

A bank with high productivity can generate the same ROA (as a bank with low productivity) even while operating at a lower NII. It can achieve this by increasing fee income per unit of asset, reducing the opex per unit of asset, or reducing bad debt charge to P&L per unit of asset on its balance sheet. This is the composite notion of bank productivity. How does one create / generate more fees from the same asset through higher sales effectiveness? How does one reduce the cost of operation while maintaining the same level of customer service? And how does one reduce the cost of bad debt even while taking risks in lending?

Exhibit 1h. Being Five Star in productivity excellence



Branch Sales and Service Excellence

"Better never than late"
— George Bernard Shaw

Globally, the primacy of branches as the principal channel for banking has been reinforced by the aftermath of the banking crisis. The importance of retail deposits in bank portfolios has gone up significantly. Bank branches are the primary vehicles to mobilize retail deposits. The benchmarking survey of banks in India has shown high variability in the productivity of branches in attracting savings customers. Exhibit 2a shows the average number of savings accounts opened in FY 2011 per branch in metro and urban areas by various banks. On an average, banks opened about 1,100 accounts per branch in metro and urban areas. While the new private sector segment has a high median, large public sector banks are not far behind. Actually, the bank with the best performance on this metric is a foreign bank followed by a large public sector bank. Old private sector and medium–sized PSU banks have lower new accounts per branch, reflecting the insufficient network effect created by smaller branch networks. However, some small banks have demonstrated how to counter the network effect and acquire as many new customers per branch as banks with large networks. Our study has highlighted four key areas of intervention to turbo–charge business growth through branches.

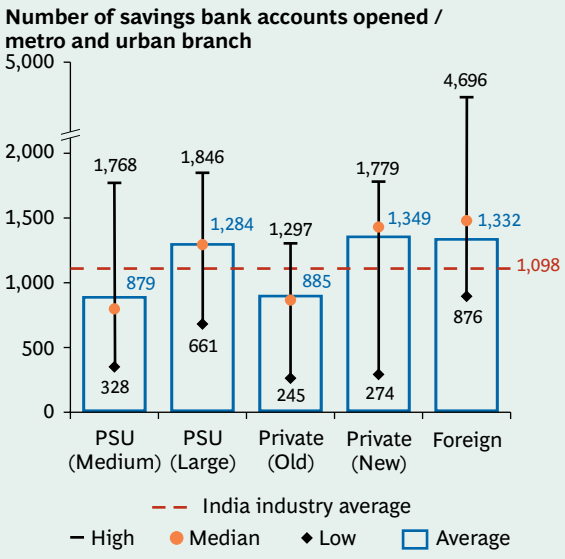
Redefine Role of Branches and Roles Within Branches

The most–efficient business models are those that ensure that the maximum proportion of staff is customer–facing. The best that we have observed internationally is 82 percent of bank staff deployed in customer–facing activities. The median observed is 71 percent. The majority of these employees are in branches in sales or service roles.

Exhibit 2b highlights the composition of customer–facing staff, as mentioned by different Indian banks in the productivity benchmarking survey.

In India, on an average, about 62 percent of banks' total staff is deployed in customer–facing activities. Out of this, roughly 37 percent are branch staff deployed in customer service — with 18 percent being branch staff deployed in sales, 6 percent working in mobile outbound sales force, and 1 percent staff serving in customer–facing channels like call centre and the internet.

Exhibit 2a. Branch sales effectiveness
Number of SB accounts opened per year per branch in metro / urban branches



Sources: FIBAC Productivity Survey 2011; BCG analysis.

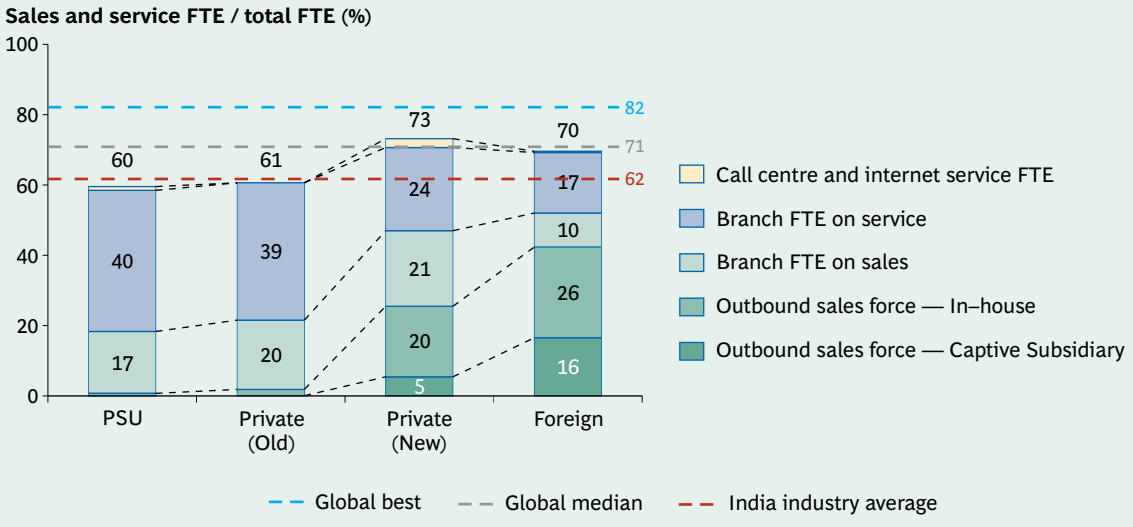
Clearly, branches are where the maximum number of customer–facing staff sits. In customer–facing roles, the 62 percent staff available is still less than equivalent median international benchmark of 71 percent observed by BCG. Among the banks in India, the new private sector has deployed the highest proportion (73 percent) of staff in customer–facing roles. The corresponding figure applicable to public sector and old private sector banks is less at around 60 percent. This is primarily because a lower proportion of branch staff is deployed in customer–facing sales or service roles in the public sector and the old private sector. Foreign banks stand out with a large portion of their total staff strength deployed in mobile outbound sales. This is perhaps to compensate for their fewer branches.

The primary imperative for deployment of maximum staff in customer–facing roles is to restructure branches and the roles of staff in branches. Exhibit 2c illustrates the composition of branch staff in different banks into sales, service, and back–office roles as mentioned by the banks in the survey. About 25–30 percent of staff is deployed in back–office activities in branches in public sector and old private sector banks. Should this proportion be reduced through appropriate Business Process Re–engineering (BPR), the efficacy of branches to generate more business would go up.

Many banks maintain traditional role definitions or job cards for branch staff. These role definitions have not been updated even after the latest technology has been adopted in branches. In BCG's experience, the role of each individual member in the branch has to be defined by such measures as time to be spent in sales, service, or other activities. Actual time spent by each employee has to be documented through time and motion studies to fine–tune the allocation. Exhibit 2d illustrates the results of one such time and motion study. The actual time spent on various activities by each of the 10 staff in the branch has been captured. Note that sales staff, in this case, are only able to spend about 40–50 percent of their time on sales. Similarly, service staff finally spent just about 40–50 percent of the time really on service. While the numbers stated in Exhibit 2b and 2c are as per the claims made by the banks in the survey, our experience suggests that the real time spent on customer–facing activities ends up being much lower than what was originally designed. Banks have to undertake a role–by–role study, in a

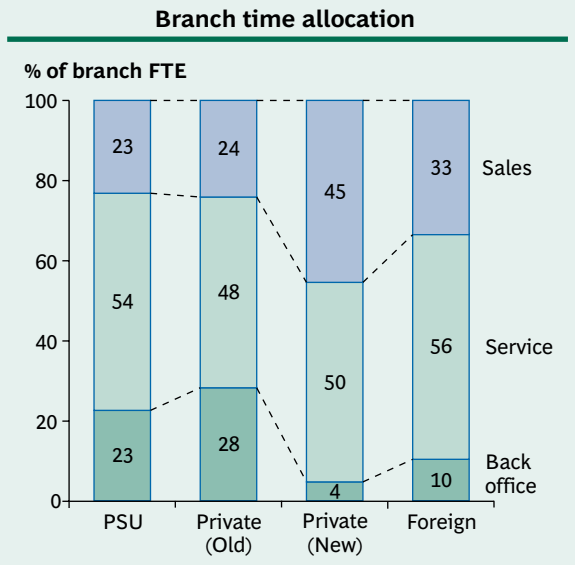
Exhibit 2b. Front office model

62% staff on sales and service



Sources: FIBAC Productivity Survey 2011; BCG RBPPB 2010; BCG analysis.
Note: FTE = Full Time Employee

Exhibit 2c. Branch time allocation



Sources: FIBAC Productivity Survey 2011; BCG analysis.

practical branch context, to fine–tune their role definitions and do further business process re–engineering to increase the available time for sales and service in branches.

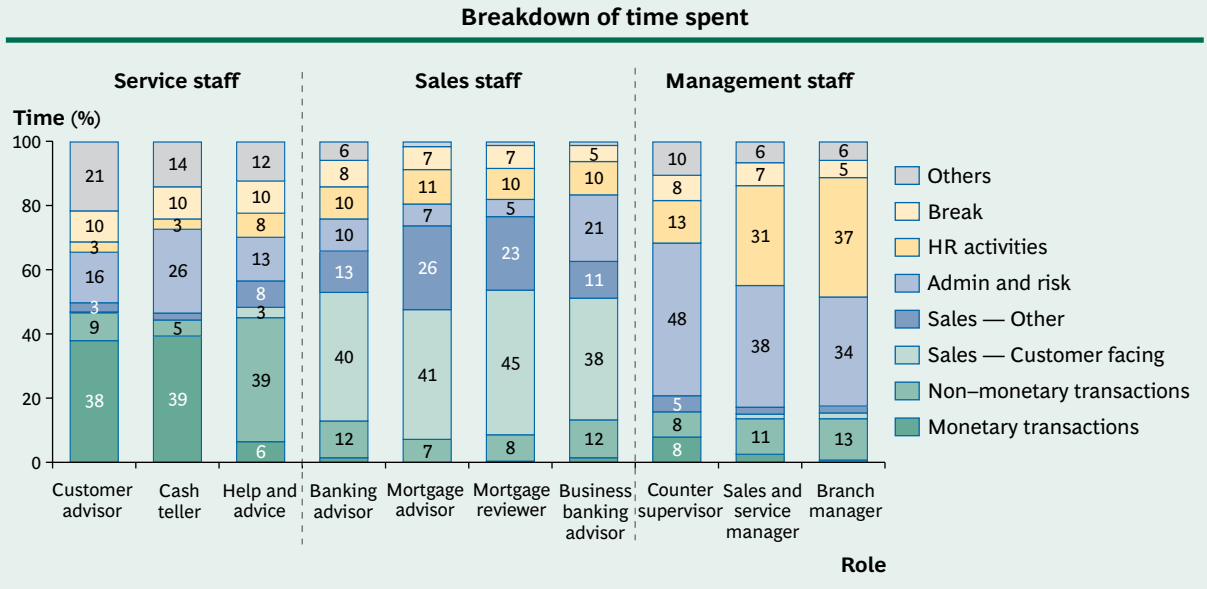
The discussion on the role of branches is incomplete without discussing the role of the branch manager. With technology allowing centralization of many decisions, branch managers are often left to execute tasks rather than to assume the role of the CEO of a local business. In BCG experience, empowering the branch manager leads to significant improvement in branch productivity. Branch managers have to be encouraged to develop their strategies within the context of the business and the competition existing in the branch catchment area. Banks have to carefully evaluate the decision rights of the branch manager to ensure that he / she has sufficient control over his / her resources and flexibility in making decisions.

Redesign of the Branch for the Next Generation

The branch with focus on sales and service looks quite different from a traditional branch. Not only are role

Exhibit 2d. Optimizing branch time on sales and service

Illustrative example from BCG project experience



Sources: BCG project experience; Time & Motion study.

definitions of staff based on customer (rather than process– or product–based job definitions), the layout of branch and space allocation also has to reflect the branch's new customer–centric role. Exhibit 2e illustrates the average size of branches in metro areas for Indian banks. There is a wide variation in size of branches of different banks. The average size of branches of public sector banks is larger. With appropriate process and role redesign, this should mean more space for customers for wait time and consultations. The private sector is adopting a small branch strategy. This helps with lower branch costs, and hence, faster branch breakeven. For banks adopting rapid rollout of new branches, this is quite helpful economically. Exhibit 2e also illustrates the average wait time in branches in India. Of the 40 banks polled for this survey, about 26 percent mentioned 2–5 minutes as the average wait time in their branches. About 65 percent banks mentioned 5–15 minutes. BCG's global benchmarking of retail banks showed a median branch wait time of 4 minutes with the best being 2.2 minutes. Clearly, service levels in branches can be improved with further business process re–engineering and role restructuring, as illustrated in the previous section.

Introduce Structured Sales Processes

Introduction of best practices in sales management is the most important lever to enhance branch productivity. There are several practices that have been observed.

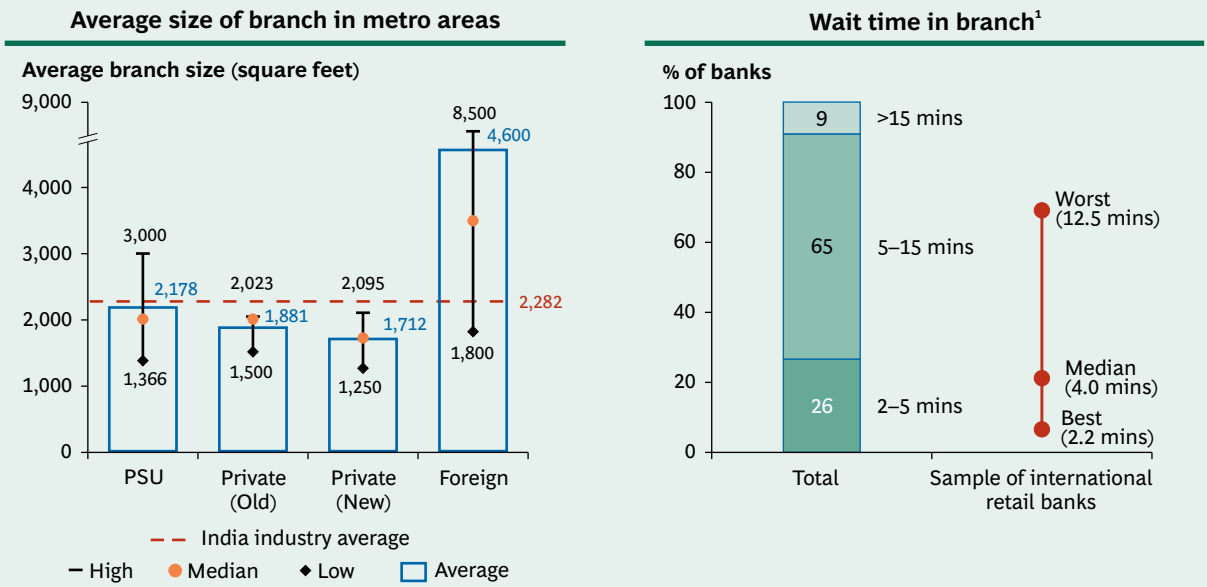
Filling the diaries of sales staff

Many organizations believe that asking people to sell and freeing up their time to meet customers is enough to push up sales. Sales staff, in such cases, is typically left to fend for itself. BCG's research and project experience have shown that this is hardly enough. The primary lever to enhance sales is ensuring that the sales staff meets as many potential customers as physically feasible. For this, the bank has to have a robust lead generation and allocation mechanism. Sales staff has to be allocated leads. The diaries of sales staff have to be filled one week in advance. CRM systems that predict customer purchase propensity have to be developed to mine existing customer database for leads.

In a fast–growing economy like India with young demographics, many new potential customers are added every day and they form an even bigger source of leads.

Exhibit 2e. Design of branch space and processes

More branch space has to be allocated to customers; processes redesigned to reduce TAT



Sources: FIBAC Productivity Survey 2011; BCG report "Operational Excellence in Retail Banking — How to Become an All–Star"; BCG analysis.
[1]Wait time for average teller transaction at a branch in CP area in Delhi is used for comparison.

Quality of sales

Sales units typically get too focused on meeting their numbers and, in the process, the quality of sales suffers. We have observed that certain practices enhance the probability of sale in a meeting and also the quality of business thereafter. Leads pursued by sales staff have to be pre–qualified with a prior telephone call. It enhances the conversion rate. Sales staff has to be trained in having conversational selling with customers wherein customer need is investigated rather than a product being pushed.

Customer on–boarding

Customers are most receptive to suggestions from the bank in the first few months after opening an account. After that, calls from the bank are not as welcome. Best–practice sales process requires that in the first few months the customer is signed up and trained to use all alternate channels including internet, bill pay, Point of Sale (POS) payments and other convenient and associated offerings. Customers also provide invaluable feedback in this time frame. Banks that listen carefully to customers in this time frame can get useful insights on areas for improvement. Most importantly, customers who have been onboarded well are typically more likely to stick around compared with others.

Resourcing aligned to potential

Often the number of resources is not in line with the potential in the catchment area of a branch. This oversight happens either because of paucity of resources or because of lack of tools to measure potential in branch catchments. Banks should develop such tools.

Simplicity in targets

Banks often give many targets to branches. Sometimes the list of targets for a branch manager could be as high as 60–90. Individual sales staff is also given many product targets to meet. This is often counterproductive. Not everyone is good at selling all products and not every catchment has potential for all products. Giving sales staff targets to sell from a composite basket of products based on a point system has been found to be more effective.

Setting in place an operating rhythm

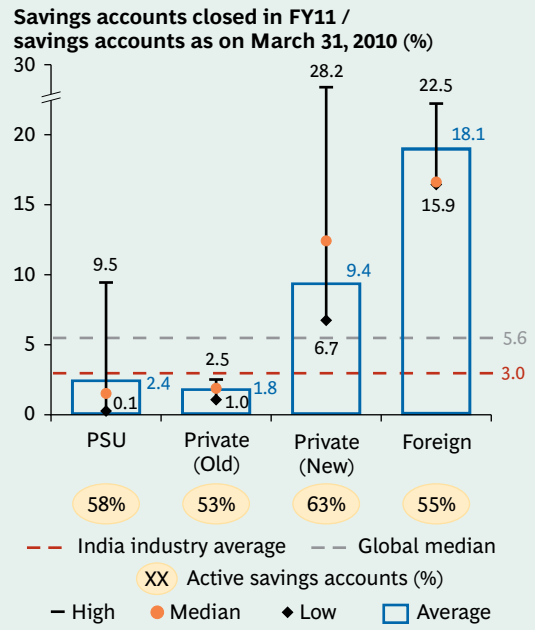
Many banks claim to have trained their branch staff on new sales processes but fail to get the benefits in higher sales productivity. BCG studies have shown that branch sales practices get institutionalized only if an appropriate operating rhythm is established in the branches. Such rhythm entails a disciplined daily, weekly, and monthly schedule. Rhythms take time to set in. Banks have to ensure that top management oversight and push stays for the appropriate duration to see to it that the rhythm is irreversibly set in place.

The managerial value–add of the regional office

There are often several layers of administrative oversight on the branches. Quite often, these layers end up aggregating the branch numbers and following up on the results. BCG experience has shown that if the layers were to focus on "inputs" (lead generation, quality of sales process, operating rhythm, etc.) as much as on "outputs" (final sales figures), the performance will be much better. The regional office should establish an operating rhythm to review the branch network on process inputs. The Management Information System (MIS) has to be redesigned to have not just final sales figures, but metrics reflecting the sales process leading to final deal closure as well.

Exhibit 2f illustrates the extent of closure and dormancy of accounts in SB in Indian banks. While at an overall

Exhibit 2f. Quality of growth
Savings accounts



Sources: FIBAC Productivity Survey 2011; BCG RBPPB 2010; BCG analysis.

level, account closure observed in India is lower than median closure observed internationally, there is still a very high variation across banks, and in some cases closure is as high as 20–30 percent. Often, the account is not closed but the customer becomes dormant. This is another leakage in the bank's productivity. Old private sector banks have reported account dormancy levels as high as 47 percent. Public sector banks and foreign banks don't fare much better either. With improvement in "quality of sales" through practices enunciated above, the wastage of churn and dormancy can be avoided and banks can become more productive.

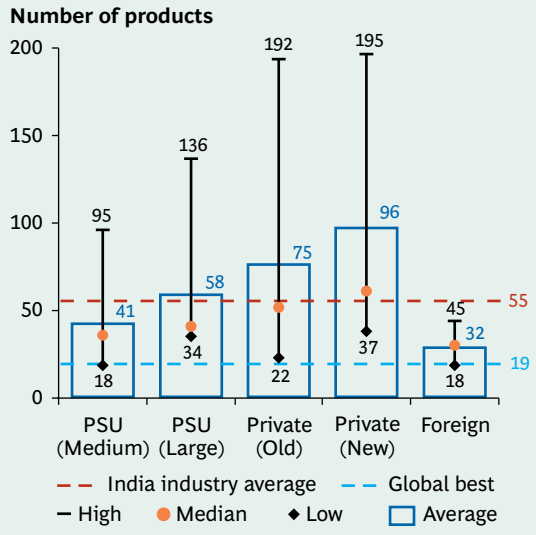
Simplify Product Portfolio

Banks often create a large number of schemes and product variants in the mistaken belief that this helps in meeting customer needs better. BCG's experience has shown that, on the contrary, a large product portfolio creates complexity for the sales staff, reducing its effectiveness. Exhibit 2g illustrates the number of products in deposits and retail advances which banks in India offer. Like elsewhere, there is a wide variation, with some banks offering as many as 200 schemes. The median value, at around 55, is close to what BCG observed in a global benchmarking of retail banks. The best practice is to establish a rigorous process of periodically simplifying the product portfolio. Simplicity of the portfolio makes the sales process more efficient and the branch staff more productive. We observed that the best practice in one of the international banks was to restrict the portfolio of products in deposits and retail credit to 19.

Public Sector Needs to Build Investment Advisory Capability

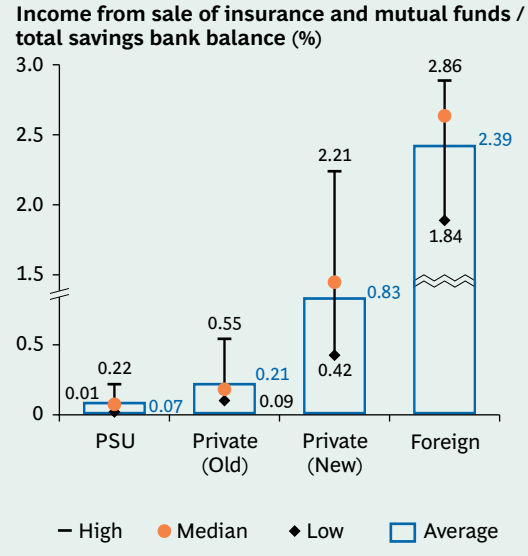
Exhibit 2h illustrates the income from sales of insurance and mutual funds for a bank as a percentage of SB balance of the bank. The idea being that SB balance accounts for the customer base to which fee–based advisory services are sold. As is clear from the chart, the majority of the public sector banks which collectively account for about 70 percent market share in deposits are virtually absent from the advisory space. The major share of this market is captured by foreign banks, followed by the new private sector banks. Public sector banks have to develop offerings for wealth management advisory services for their customers. It is a natural product to offer

Exhibit 2g. Simplicity of product portfolio
Deposit[1] and retail credit product



Sources: FIBAC Productivity Survey 2011; BCG RBPPB 2010; BCG analysis.
[1]Savings, current and term deposit.

Exhibit 2h. Branches can deliver higher fee income



Sources: FIBAC Productivity Survey 2011; BCG analysis.

from the branch network as it requires consultations in the trusted and secure environs of a bank branch. Further, with growing income and wealth levels among customers, investment advisory is a mandatory product for banks to offer. Generating the maximum fee income from the branch network is crucial to productivity excellence in banks. Public sector will be exposing itself to threat of customer attrition in future if this genuine need of customers is not fulfilled properly.

New Channel Excellence

"The best way to predict the future is to create it"

— Peter Drucker

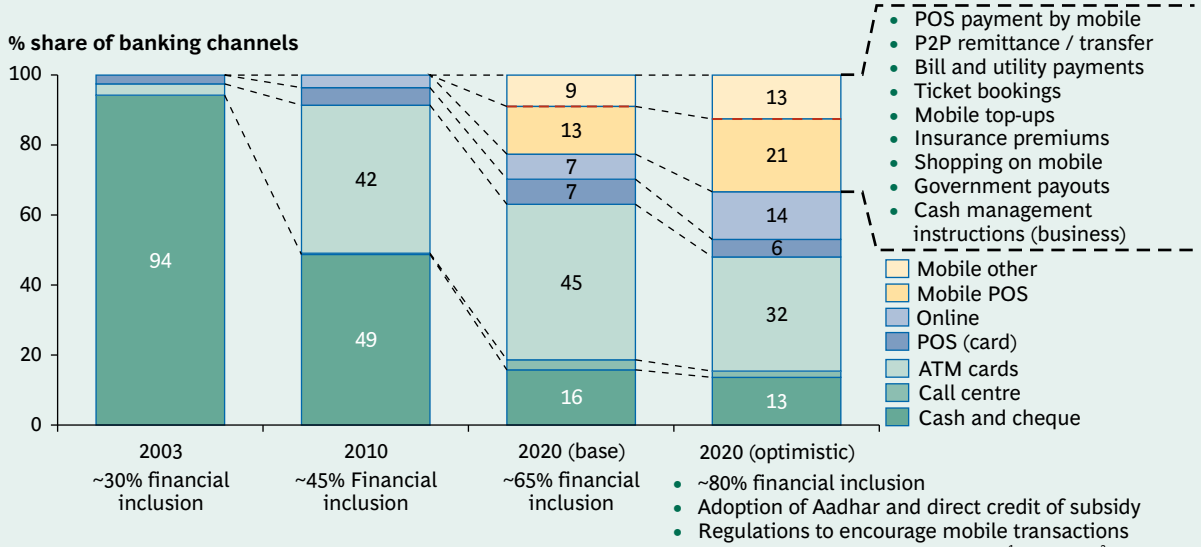
In last 4 years, the number of ATM transactions increased three times from about 1,500 million to about 4,200 million. Such explosive growth in the usage of new channels is going to characterize the next decade of Indian banking in the same way as rapid growth in retail lending did in the last decade. This trend offers a whole range of opportunities for Indian banks to differentiate themselves, to improve customer service, to generate new leads for sales, and to reduce costs. The productivity survey revealed that many banks may not be ready to harness this opportunity.

Embrace the Mobile

Five alternate channels for transactions — ATM, internet, mobile, call centre, and POS, have all reached critical mass in the Indian market and are poised for rapid development in terms of depth of penetration and breadth / quality of service. Mobile phones lead the evolution by far. Exhibit 3a captures how the face of Indian banking will change during the next decade. It shows the percentage composition of transaction volumes by channel in 2003, 2010, and as projected for 2020. Cash and cheque, which dominate the

Exhibit 3a. Banking will not be the same

Transaction profile of India is expected to dramatically change



Sources: FIBAC Productivity Survey 2011; RBI reports; Central banks of Germany, US and South Korea; World Bank population data; "The Mobile Financial Services Development Report" by World Economic forum in collaboration with BCG; BCG analysis.

[1]Direct tax code.

[2]Goods and services tax.

transaction profile at present with 49 percent of transactions, are expected to go down to 15 percent. Mobile banking which constitutes just about 0.1 percent of transactions will be the second largest channel after ATM (in the base case scenario). A significant proportion (20–30 percent of total) of transactions could happen via mobile phones by 2020 in optimistic scenario if a number of industry, regulatory, and government initiatives were to fructify.

Indian banking will chart a different evolutionary course compared with other developed economies which evolved and matured at a time when mobile technology was not yet ready. Mobile technology will impact banking transactions in many waves:

Online banking on mobile

Customers will be allowed access to account on mobile phone. Beyond information access, transactions like bill pay, account–to–account funds transfer, and service requests will be feasible. Such mobile banking will replace online banking because of greater convenience that will induce new users, who do not have regular access to the internet, to adopt mobile banking.

Mobile commerce — acceptance

Smartphone technology is making the device quite versatile. With a few attachments, it can act as a Point of Sale (POS) device for accepting payments. This can revolutionize POS debit and credit card acceptances. The primary barrier to rapid growth of POS debit (or credit) is the high set–up cost for a conventional POS device. With a mobile phone morphing into such a device, this barrier will fall.

Mobile commerce — payments

Innovation in mobile–phone technology is taking place at a rapid pace. It is conceivable that within next few years we will have cheap enough phones with Near Field Communication (NFC) technology built in to facilitate Peer–to–Peer (P2P) money transfer almost instantaneously. At this stage it is also conceivable that most of the payers at POS will be using mobile phones instead of cards to make payments. Many small daily P2P transactions like payments to sundry vendors will move from cash to mobile phone.

Given that mobile transactions cost a fraction of ATM or branch transaction, the enormous productivity enhancement that will accrue to banking system can hardly be overemphasized.

Exhibit 3a depicts an optimistic scenario that we argue is worth a concerted effort by industry, government and RBI. It envisages a scenario of 80 percent financial inclusion in India with bank accounts opened for vast majority and serviced profitably leveraging the low cost advantage of new channels — especially mobile which is accessed by more poor people than any other channel. Industry has to invest in innovation now. Government has to ensure that well intentioned initiatives like Aadhar, direct credit of subsidies to beneficiaries, Direct Tax Code (DTC), and Goods and Service Tax (GST) are implemented in right earnest. They will reduce the need for / avenues for black money transactions and bring large number of small transactions into the books of banking industry.

If low cost channels are made available by the banking industry, a large portion of these transactions will move to the lowest cost channel — principally to the mobile phone. Low cost interbank payments and settlement utility promoted by NPCI (RuPay) will provide the crucial infrastructure for mobile transactions being projected. Lastly, RBI has a crucial role to play. Regulation in this case has to encourage and facilitate innovation, not just permit experimentation. If conventional players do not do enough to invest in innovation, new players with specialized licenses may be considered.

Leverage New Channels for Productivity Enhancement

New channels enhance bank productivity in four ways:

- Decrease cost to serve: Cost of transaction in new channels is much lower compared to equivalent transaction at a branch. By encouraging customers to use new channels, banks can reduce the total cost to serve them. Minimum viable ticket size of business can be reduced and more customers can be profitably served.

- Reduce customer churn: It has been found that once customers get used to the multichannel transaction experience, chances of churn are substantially reduced. This is specifically true of high–convenience services such as online payments and bill pay which have a significant setup effort and hence, high switching cost.

Further, five channels offer banks a whole new range of customer touchpoints where there is possibility of differentiation.

- Increase cross–sell: New channels offer customer touchpoints that can be used to generate new leads from existing customers. ATM is a powerful source of new leads from existing customers.

- Increase new client acquisition: New channels — especially internet — are used for prepurchase information gathering and product comparison. Social media is expected to be an important channel for brand building and referral. For some banks, as many as 50 percent of hits on their ATM are of non–customers. Clearly it is a major opportunity for new leads.

It is clear that for both revenue uplift and cost containment, new channels will be at the center stage of bank productivity enhancement initiatives.

Ensure Adoption: Get Over the Hump

Like most things that require a change in consumer habit, the biggest challenge for banks in new channels is ensuring adoption. Exhibit 3b illustrates the percentage of active savings accounts that have had at least one transaction through ATM, debit card at POS, internet, or mobile phone. Despite the massive increase in ATM transactions witnessed lately, just about 54 percent of active savings accounts had an ATM transaction in the last six months in metro areas. For non–metro areas, the number was much lower at 33 percent. The adoption rates for POS debit, online, and mobile were lower at 30 percent, 15 percent, and 2 percent, respectively, in metro areas.

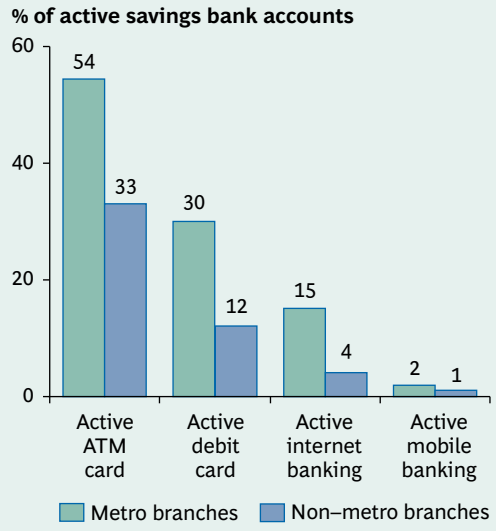
Beyond a tipping point, however, adoption increases at a rapid pace. The explosive growth in the number of ATM transactions in the last 2–3 years is a testimony to, as well as, a sneak preview of what is to come. The moot point is how to get customers to try the new channel and experience the new convenience and liberation it offers. Banks have to roll out concerted campaigns to induce trials. Many international banks do not give full marks to their sales force for new customer accounts unless all the new channels have been used at least once. Customer onboarding process deployed in the first 3–6 months of an account opened is crucial. Rewards programs can be offered to customers to motivate usage of new channels.

For mobile applications, employees have to be trained to help customers download the banks' applications onto their mobile devices — and also to help them overcome the inevitable teething troubles of getting started. Most banks in India do not have such processes or programs in place. They should anticipate the upcoming revolution and put these systems in place.

A basic necessity in growing adoption is ensuring a delightful customer experience. Banks have a lot of ground to cover here. A recent survey of retail banking customers conducted by BCG has revealed that new channels are primary sources of customer dissatisfaction.

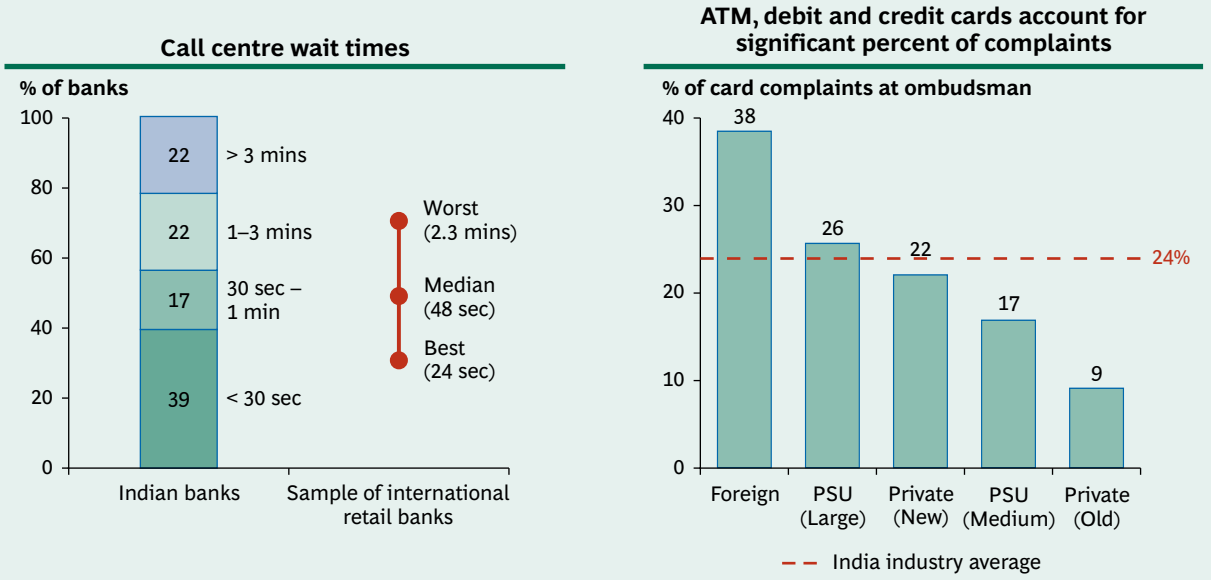
Exhibit 3c illustrates select aspects of service on new channels in India. Bank call centres have gained notoriety for long wait times and the complexity of Interactive Voice Response (IVR) navigation. Almost 40 percent of banks in India revealed in the productivity survey that their wait time was more than a minute at the call centre. The median observed in leading retail banks worldwide is 48 seconds. About 25 percent of total customer complaints that reach the ombudsman are for card products that relate to new channels.

Exhibit 3b. New channel usage in India
SB accounts activity[1] details



Sources: FIBAC Productivity Survey 2011; BCG analysis.
[1]Accounts with more than 1 customer initiated transaction over the past 6 months.

Exhibit 3c. Customer service in new channels



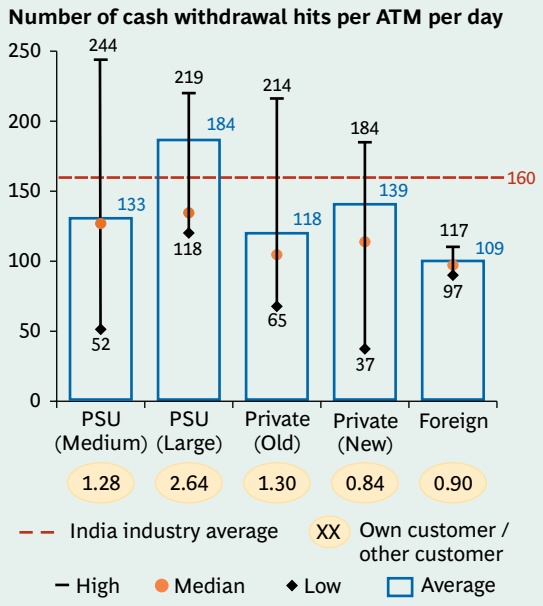
Sources: FIBAC Productivity Survey 2011; RBI data; BCG report "Operational excellence in retail banking — How to become an All Star"; BCG analysis.
Note: The RBI data on complaints received at banking ombudsman offices for the year 2009–2010.

Extract Full Potential of ATMs

ATM usage has exploded in the last few years. However, we are nowhere close to maturity of the channel yet. Even as the number of ATMs rose in the last few years, the number of transactions per ATM rose even faster. From about 70,000 at present, we expect the number of ATMs to expand to about 250,000 by 2020. Banks have achieved varied levels of success with ATM adoption and migration of transactions. Exhibit 3d illustrates the number of cash withdrawal transactions per ATM for banks in different categories. A few banks in each category have achieved very high levels of transactions (200 transactions per day per ATM, which is close to the highest in the world). There is no scale evident in the level of usage in ATM network. A few banks with small networks are as successful as a few banks with large networks in achieving high usage. The most successful public sector bank is as successful as the most successful bank in the private sector. There is an interesting pattern, however, in the usage of a bank's ATM by non–bank customers. More than half of the transactions on ATMs of new private sector banks are from customers of other banks. For large public sector banks, this number is just

Exhibit 3d. ATM utilization

Number of cash withdrawal hits per ATM per day



Sources: FIBAC Productivity Survey 2011; BCG analysis.

about a quarter. Some new private sector banks are known for their ATMs as a primary vehicle of service. This is a simple yet powerful fact. ATMs, located strategically, managed with high uptime, and maintained in pleasing ambience, can be a rich touchpoint with new customers and can potentially generate leads for customer acquisition. ATM networks can be used to extend the catchment area of branches. They can also enhance the perception of a bank's presence even when it has only a limited number of branches.

There is significant scope for higher quality, more breadth, and greater customer delight in the ATMs. Banks that invest now could reap the benefits in terms of customer satisfaction and new acquisitions. Making deposits at ATMs can be made more intuitive and safe. Privacy of transactions can be improved. There is significant scope for personalization of interaction and generating leads from customers for new products.

Be the New Channel Champion — Who will win the next battle in Indian banking?

New private sector banks gained an upper hand in Indian banking landscape when they entered the market against the incumbent public sector banks with core banking technology, internet banking, and ATMs. In the last decade, almost all of the public sector banks have completed the implementation of core banking systems. ATM and internet banking have been put in place. Most banks have launched some form of a mobile banking platform. The early lead of new private sector banks has now been leveled at least in terms of what is being offered. The stage is now set for the next battle in retail banking. This will be characterized by massive adoption and proliferation of new channels — as measured by depth and breadth of usage by customers. Odds are even. Most banks have a fair chance of establishing a lead in the next battle for Indian consumers.

Even as the banks are busy catching up with massive growth, they have to set aside resources to contemplate, pilot, and fine–tune the channels and services for the future. There are many areas that need investigation, e.g.:

- Is the bank investing in next–generation mobile banking applications? Such investments have to be made in advance in anticipation of the three waves in usage of mobile phones for banking — online banking on mobile, usage of mobile phone on POS for acceptance, and P2P payments on mobile phones.

- The advent of 3G in mobile telephony in India can open many avenues for richer service delivery. Priority customers, who are otherwise not viable for a dedicated relationship manager, can get "face to face" financial planning advice on their mobile devices from a set of centrally located advisors.

- ATMs are likely to continue to be installed at a rapid pace for the next several years in India. Those banks which have a strategy in place to use ATMs as customer acquisition tools as much as low–cost transaction tools will gain an edge. What additional services and differentiated experience is the bank planning to offer through its ATM?

- Presence on social media can be a powerful source of branding, customer acquisition, and generating feedback from young customers who will be critical for growth. What is bank's presence on social media?

- Adoption of existing channels by the current customer base has to be tracked and worked upon as a strategic initiative. This will require investment in customer education and trial induction. Customer onboarding processes have to be put in place.

New channels will be a primary driver of productivity enhancement in Indian banks in the next decade. Success will depend on initiatives taken by the banks now.

Lean Operations and Operating Model

"There is nothing so useless as doing efficiently that which should not be done at all"

— Peter Drucker

Non customer–facing activities of the bank have to be optimized in a manner that these take the least amount of time and resources but maintain the desired levels of customer service, flexibility, and control over risks. After sales and service, the next highest number of employees are engaged in back–office operations and that should be the first priority for optimization.

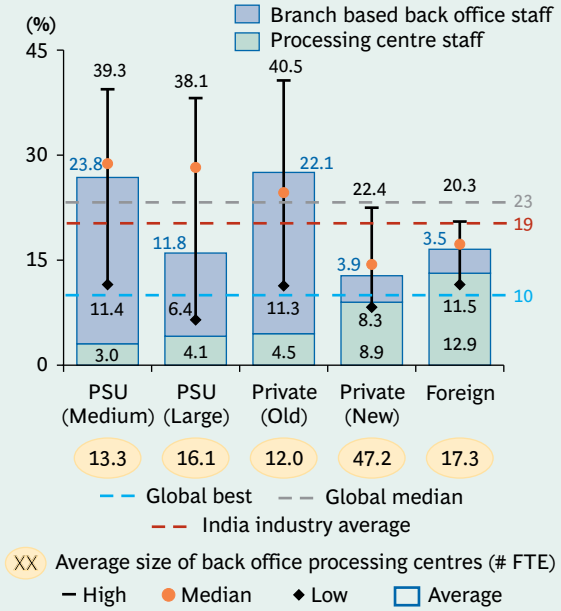
Exhibit 4a illustrates the level of operations staff in various banks in India. The exhibit shows the operations staff split into branch–based staff and centralized processing unit–based staff. The average proportion of FTEs in back–office operations in India, according to the productivity benchmarking survey of Indian banks, is about 19 percent. This is similar to the median of the global sample. Like elsewhere, there is a broad range among the banks in India. Some banks have as high 40 percent staff in back office processing. They need urgent correction. New private sector banks and foreign banks, in general, are below the average. Only a handful of banks are close to the global best–practice benchmark of 10 percent.

Another measure of productivity is the extent to which the back–office staff is based out of dedicated processing centres as against branches. On this dimension, the public sector and old private sector banks have significant ground to cover with the majority of their back office staff still working out of the branches. A significant portion of the back–office staff of new private sector and foreign banks is in the processing centres.

The third measure of productivity is the extent of scale in the back–office processing centres. The bubbles in Exhibit 4a at the bottom of the bars depict the average size of back–office processing centres (average number of FTE per back–office processing centre). On this count, the industry has some ground to cover — average size of back–office processing centres in India range from 15–50. The global benchmark observed by BCG is a median of 250 staff per processing centre. The number observed in a sample of 20 global retail banks is 760 FTE per centre.

Centralization of processes is sometimes blamed for poor customer service. This is a failure of centralization. In

Exhibit 4a. Composition of operations staff
(Branch back office + processing centre) / total



Sources: FIBAC Productivity Survey 2011; BCG analysis.
Note: Processing centre staff includes staff in data centres and processing units; Total staff includes the captive subsidiary staff

BCG's experience, such failures can be avoided by adopting two principles:

1. Create lean processes through customer–centric BPR

2. Align operating models to the business units

Create Lean Processes Through Customer–centric BPR

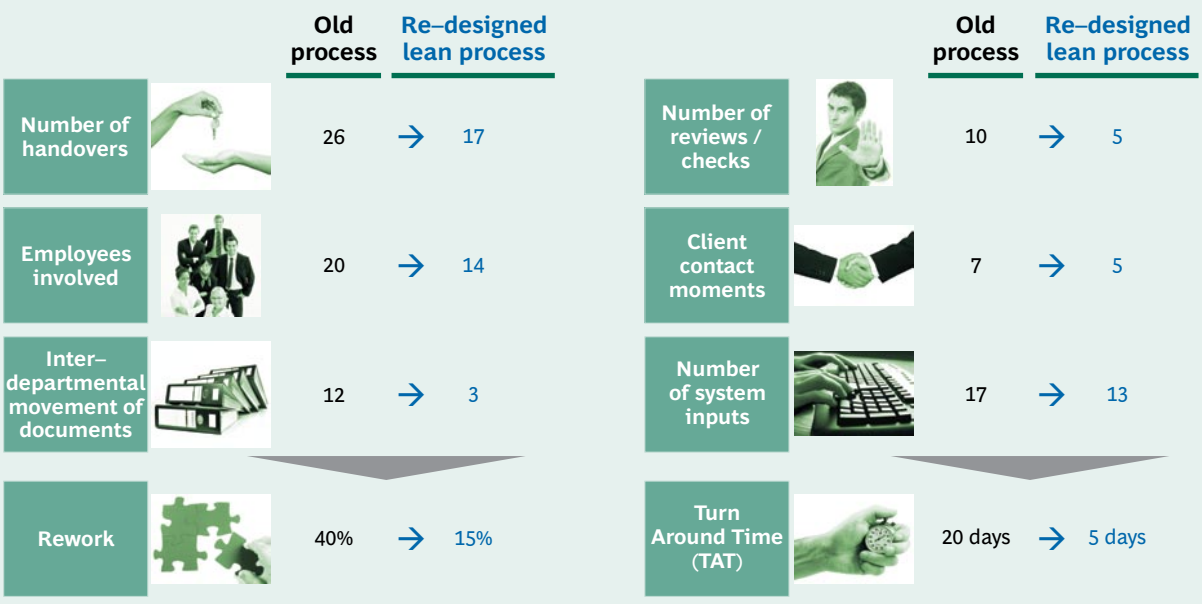
Process re–engineering based on principles of lean design should lead to simultaneous lowering of costs, improvement in customer service, higher quality, and reduction in risks. BPR must be customer–centric. It should break the compromises between process cost and customer service to avoid failures of the type discussed above. Exhibit 4b is an example of successful redesign of a loan sanction process in the Indian market. A redesigned Lean process is created by reducing non customer–value–adding activities in the traditional process. Such non value–adding activities include too many handovers between employees, involvement of more employees than required, unnecessary physical movement of papers, repetition of checks and reviews, redundant client contact points, and more system inputs than the minimum necessary. As shown in Exhibit 4b, a critical examination of current process with an objective to identify wastage led to more than 50 percent reduction in Turn Around Time (TAT) for customers and more than 50 percent reduction in rework — resulting in higher employee productivity. Less number of handovers and system inputs means lower chances of error and reduced operating risks.

Analysis of the TAT claimed by the banks in the productivity survey highlights the room for further process improvement in the Indian industry. Exhibit 4c compares the TAT from mortgage application to sanction in the Indian banking industry with a sample of large global retail banks. A mere 17 percent of banks in India claim to offer sanction within 1–3 days of submission of application. 83 percent need more than three days. On the other hand, 55 percent of the leading international retail banks in the sample claimed to offer conditional sanction within the same day.

There is significant room for further BPR in Indian banking. Exhibit 4d highlights the percentage of banks in

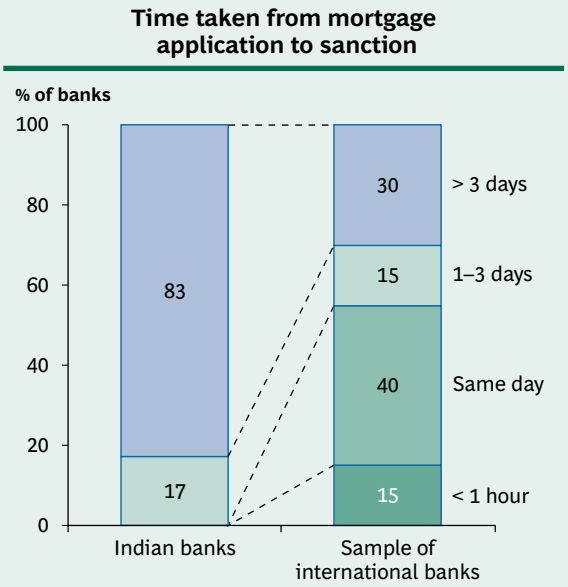
Exhibit 4b. New vocabulary in process excellence

Reduce TAT for customers, increase productivity of employees, and reduce operating risks



Source: BCG project experience.
Note: TAT = Turn Around Time.

Exhibit 4c. Turn Around Time



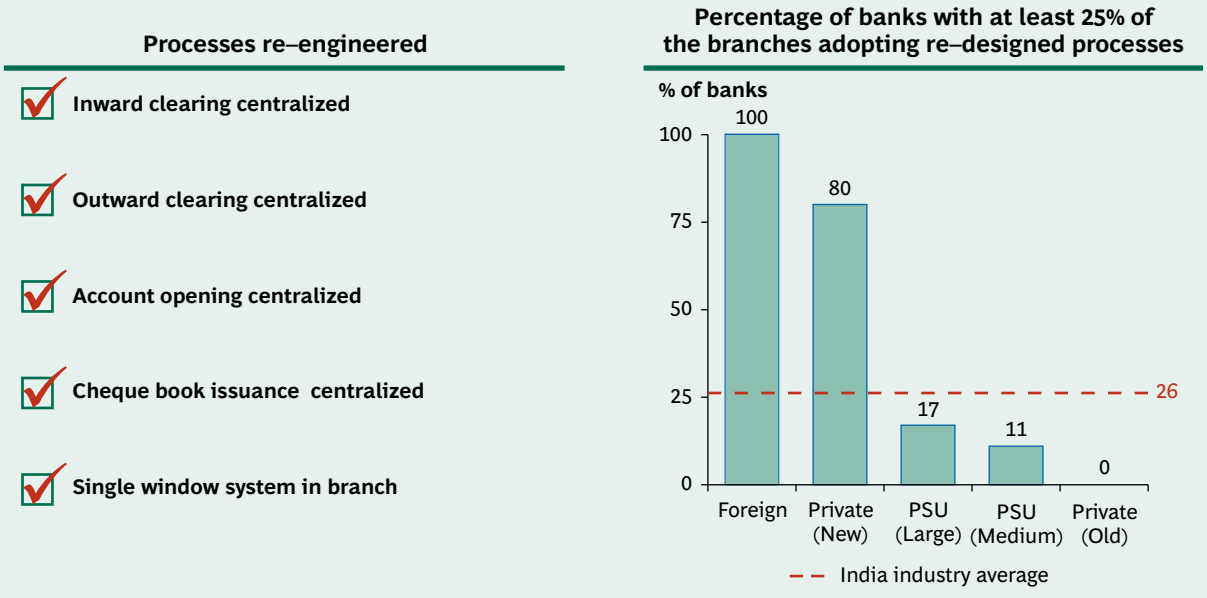
Sources: FIBAC Productivity Survey 2011; BCG report "Operational Excellence in Retail Banking — How to become an All Star"; BCG analysis.

different categories where at least 25 percent of branches have five key branch processes centralized or redesigned (inward and outward clearing, account opening, cheque book issuance, and adoption of a single–window system). New private sector banks have had a head start because these did not have legacy processes to redesign. The old private sector is lagging behind the most in adopting process re–engineering, followed by the smaller public sector banks.

Align Operating Models to the Business Units

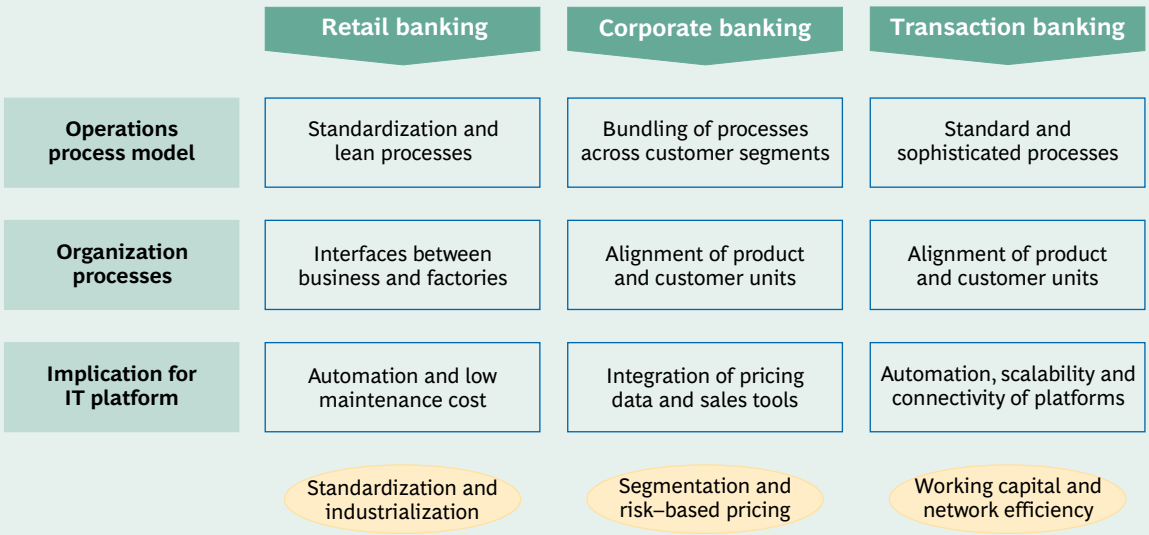
Processes should be redesigned and optimized in each Business Units (BU) based on end–to–end appreciation of business model and economics. Value from operations BPR may come if redesign in operations is complemented with appropriate change in organization design and IT platforms. Further, priorities vary among BUs. Exhibit 4e illustrates the differences in priorities between a retail bank, a corporate bank, and a transaction bank on operations process model, organization processes, and implications for IT platform. For the retail bank, standardization, centralization, and consolidation of

Exhibit 4d. Extent of Business Process Re–engineering



Sources: FIBAC Productivity Survey 2011; BCG analysis.
Note: As claimed by banks in FIBAC Productivity Survey 2011.

Exhibit 4e. Operating model needs meticulous design
Needs to be customized to business unit



back–office processes are key success factors. BPR has to focus on them. It leads to the need for redesign of organizational processes in the form of the interaction mechanism between BUs and back–office factories for smooth handover and coordination of customer interactions. In this context, the demand on IT is for a high level of automation and low maintenance cost. The exigencies are different in corporate banks. Centralization of processes in corporate banks can lead to compromise on customer service without any major cost savings. The focus of process redesign in a corporate bank has to be on creating synergies in operations processes among different customer segments. The critical organization process in a corporate bank is to create alignment between product and customer segments to ensure a seamless interface. Transaction banks, even though similar to corporate banks, have different priorities from corporate banks.

Significant Increase in IT Investment Required in the Public Sector

Process excellence critically depends upon the quality of the underlying technology platform. Most process changes cannot be implemented without the appropriate upgrade in technology. Almost all banks in India have achieved close to 100 percent implementation of the Core Banking System (CBS). What next? Banks should invest in technology systems that can facilitate better decisions through richer information capture, automate workflow by eliminating paperwork, and help sales staff identify leads to pursue. Exhibit 4f highlights five such new areas that require technology investment. The chart shows the percentage of banks in various categories which claim to have relevant investments in all the five areas. The chart highlights significant gaps in investments in technology, irrespective of bank category.

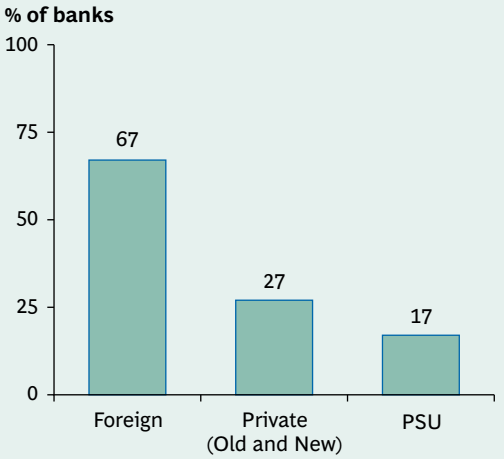
Exhibit 4g corroborates this IT underinvestment in figures. The chart shows investment and expenditure on IT as a percentage of revenues for various segments of the Indian banking industry in FY 2011. On an average, Indian banks spend about two percent of their revenues on technology. The figure is a bit higher for new private sector banks, at four percent. BCG's survey of leading European banks found that the median expenditure on IT as a percentage of revenues in Europe was about nine percent.

Exhibit 4f. Next generation systems key to productivity enhancement

Next generation systems capabilities

- ☑ Systems allow for customer level view across all products
- ☑ Systems allow for return on capital assessment on deals with customers
- ☑ Data warehousing for risk management modelling and customer relationship management
- ☑ Workflow automation in HR processes
- ☑ Workflow automation in retail credit process

Percentage of banks with all ticks (✓)



Source: FIBAC 2011 survey responses

It is improper to expect Indian banks IT spend to match western banks due to differences in cost of IT manpower. However, the significant gap does merit investigation.

Public Sector Needs a New Strategy for IT Investment Beyond CBS

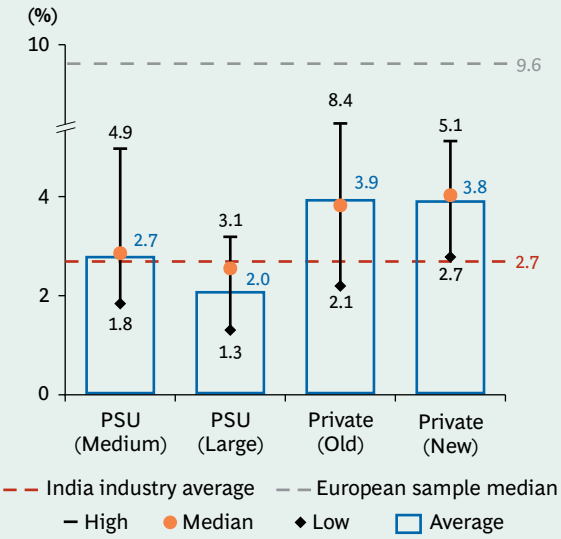
The underinvestment in IT is most severe in public sector banks. As depicted in Exhibit 4g, public sector lenders spend about half of what their new private sector peers spend on IT and less than a quarter of what comparable Western banks do. To retain their competitiveness and customer service levels, public sector banks will have to ramp up their technology capability. This is one of the biggest strategic priorities and challenges for the sector.

Implementation of the Core Banking System (CBS) was a necessity and a given. It was in a sense a low–hanging fruit that has been captured by all banks. Investments beyond CBS are not "a given." They need a careful strategy.

- IT strategy is required to create a coherent and integrated IT architecture. Uncoordinated investments

Exhibit 4g. Investment in technology

Capital and operating expenses in IT / revenues



Sources: FIBAC Productivity Survey 2011; BCG's European IT benchmarking in banking 2010; BCG analysis.

in technology by banks can, over time, lead to severe complexity and costs. Western banks are laden with huge costs of maintenance of legacy systems. Investments made on a one–off basis lead to poor IT architecture where systems do not integrate seamlessly. Customer service suffers, the bank's speed of response decreases, flexibility to offer new features reduces, and operating risks increase.

- Next generation investments in IT require stricter measurement of Return on Investment (ROI). BCG's project experience has demonstrated that beyond the "mandatory" investments like CBS, large IT investments typically destroy value. Simple and low–cost IT solutions are often able to generate the same or better results as compared to costly branded software.

- User–led implementation methodology: Value from large IT investments is elusive because user acceptance is not high enough to generate the required reduction in costs or uptick in revenues. Next–generation IT investments have to involve users up front in system requirements specification, testing, creating awareness and acceptance, and finally extracting value.

High–Performance Organization Design

"Productivity of work is not the responsibility of worker but of the manager"

— Peter Drucker

How the workplace is organized impacts the productivity of workers. Careful design of organization can provide the right foundations for a high level of engagement and productivity in the workforce. However, changes in organization should be made only after careful thought. Organizational changes are not easily reversible, because these survive in the perceptions of people. Perceptions take a lot longer than reality to change. The productivity survey has highlighted five areas of organizational intervention that can spur higher productivity in Indian banks.

Lean Overheads: Cut with Care

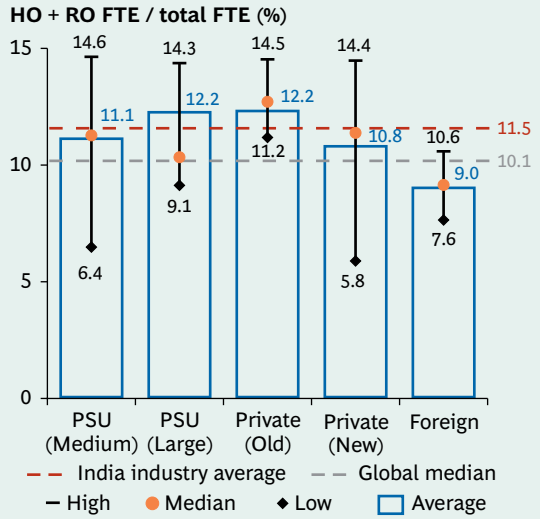
Exhibit 5a illustrates administrative FTE as a percentage of total FTE in Indian banks. Administrative staff account for about 11 percent of total staff in Indian banks. This compares well with about 10 percent observed by BCG in banks, on an average, worldwide. Administrative staff includes all employees in head office, regional offices, and other such layers above branches. It does not include workers in back–office processing centres and business development teams that are not based at the branches. Some banks in India have as low as 7 percent administrative staff. Others have as high as 15 percent.

Clearly there is a wide range in productivity of overhead administrative staff. Scale effect is not visible. Large banks, on an average, do not have lower administrative overheads. It is clear that many banks can enhance productivity significantly by optimizing their overheads.

Reduction in overheads has to be exercised with great caution. Wrong cuts can be retrograde and debilitating. A common mistake made by some organizations is to pursue a blanket reduction of one tier in the organization hierarchy ("four tiers to three tiers"). This is often counterproductive. Different businesses require different number of tiers to provide effective spans of control. Corporate banking needs a two–tier structure; SME banking needs a three–tier structure; retail needs four tiers or more. Organizational tiers have to be aligned to the economics of the different businesses.

BCG's proprietary Delayering™ methodology for the creation of Lean organization design with optimum

Exhibit 5a. 11% of the total staff in administrative offices



Sources: FIBAC Productivity Survey 2011; BCG global enterprise excellence database for banks; BCG analysis.
Note: The total staff includes the staff of captive subsidiary and outsourced staff. Administrative offices include Head office and Regional / Zonal / Circle offices. It does not count staff in processing centres, direct sales and business development teams not sitting in branches.

administrative overheads is based on the idea of optimum span of control at every level in the organization. On an average, a span of control of five to seven is considered optimum (unless the role is too simple and can afford more, or is too complex and deserves less). Often, bloated administrative offices have many positions with spans of control as low as two or three. Optimum spans of control at each level ensure that all managers are appropriately stretched and there is no micromanagement.

Exhibit 5b illustrates the framework used by BCG to bring about a balanced reduction in overhead costs and, at the same time, enhance the quality and speed of decision making in the organization. Three primary drivers of overhead cost reduction also lead to faster and better decisions.

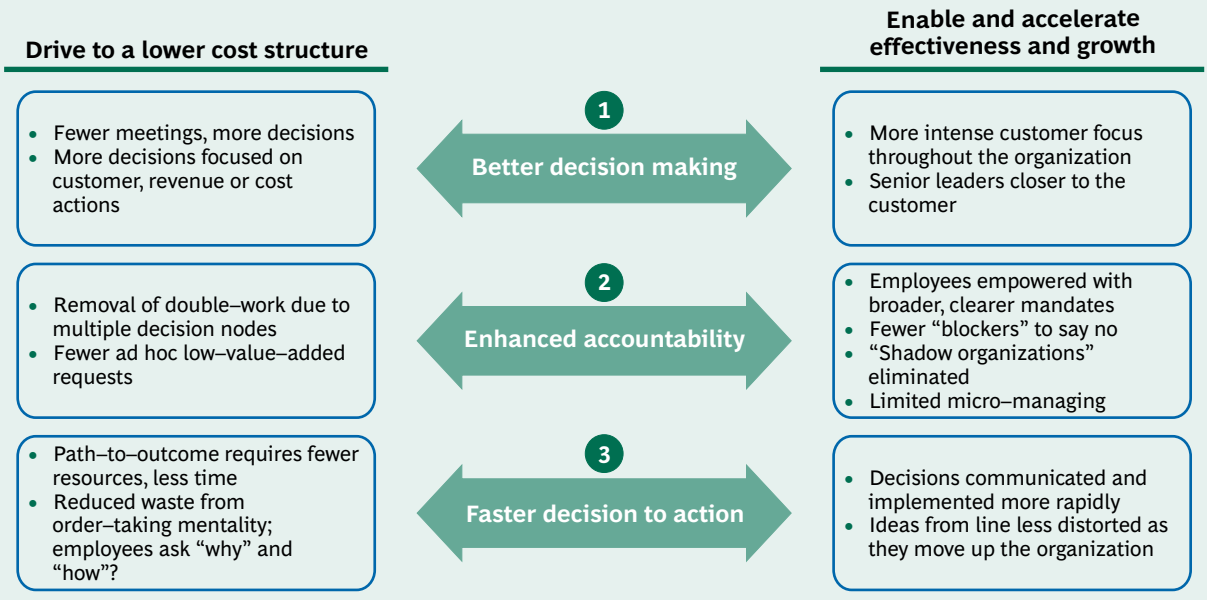
- Focus on reducing the number of meetings and increasing the number of decisions made per meeting leads to better utilization of top management time.
- Similarly, focus on elimination of "double work" (once in the BU and then at the corporate centre) leads to higher empowerment of employees.
- Removal of wasteful reviews increases speed of decision.

Bolster Finance and HR Expertise

Exhibit 5c illustrates the finance and HR manpower of banks in India as a percentage of total manpower. On an average, the finance function has about 1.3 percent manpower and the HR function has about 0.6 percent of staff in Indian banks. Globally, the average for banks is about 5 percent for finance and 1.5 percent for the HR function. Banks in India typically work with less than half of the benchmark staff strength for finance and planning as well as HR. There is a wide variation observed in these ratios among the surveyed banks in India. Clearly the practices vary.

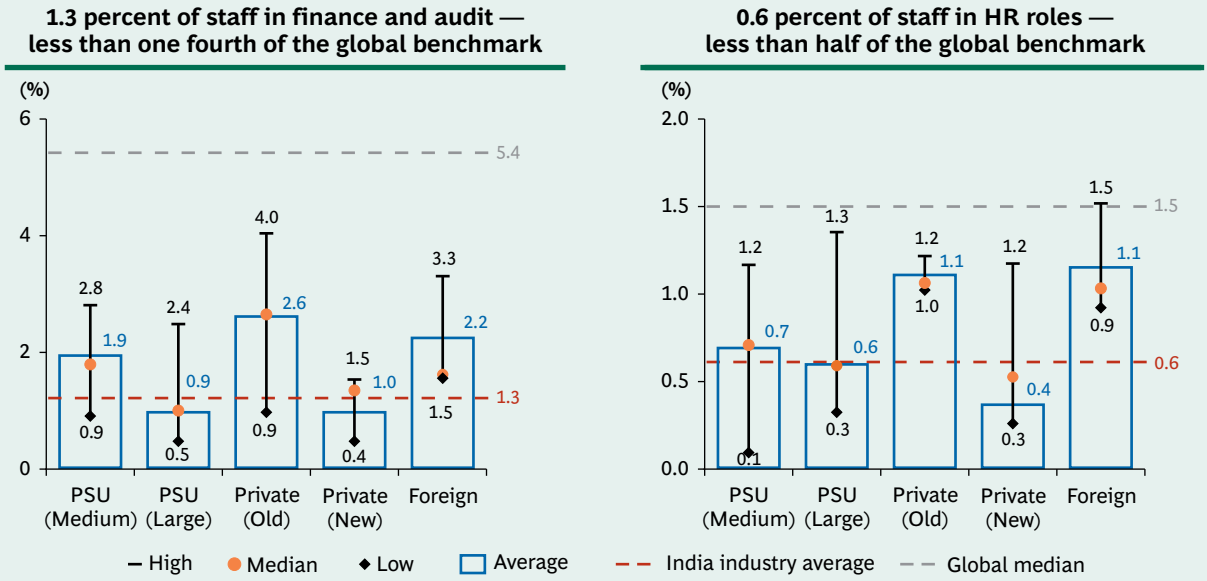
The key issue in finance and HR is not about cost reduction but expertise and capability enhancement to implement best–in–class performance measurement systems and HR practices to improve employee productivity. Considering current levels of underinvestment, many banks will benefit by augmenting their HR and finance teams with expert skills.

Exhibit 5b. Attaining overhead efficiency by better decision making processes



Source: BCG project experience.

Exhibit 5c. Staff in support functions



Sources: FIBAC Productivity Survey 2011; BCG global enterprise excellence database for banks; BCG analysis.
Note: The total staff includes the staff of the captive subsidiary as well as the outsourced staff.
[1]Finance includes planning, accounting and corporate finance staff at head office and other administrative offices like regional office, zonal office, circle office, Local Head Office (LHO), etc.

Invest in Performance Measurement: Measure New Things to Get New Things Done

Like any other area of performance, productivity excellence is possible only with meticulous measurement. Traditional measures of performance assessment do not explicitly have productivity metrics. Banks should be able to ascertain product–level and BU–level net profitability on a full–cost basis; capital has to be allocated to businesses and return on risk–adjusted capital calculated for businesses and products. Also, productivity metrics should be measured and targeted, and employee performance assessment linked to such metrics. For most of the above, banks should invest in a capable management accounting team distinct from their financial accounting departments. Exhibit 5d illustrates the percentage of banks in different categories which affirmed the existence of capabilities and systems on each of these five areas. Banks, in both private and public sectors, have to make these investments. Banks need to augment the finance and HR teams with number of quality of staff who can operationalize and institutionalize new performance measurement systems.

Reform the Public Sector Compensation Model

BCG's project experience has demonstrated that incentive compensation is the most powerful lever to enhance productivity. Typically, variable compensation at 15–20 percent of fixed compensation is found to be effective in providing credible incentive. Exhibit 5e illustrates variable compensation as a percentage of total employee cost in Indian banking for various banks. On an average, the industry has two percent variable compensation. New private sector banks and foreign banks operate close to the benchmark range of variable compensation of 15–20 percent. However, there is a significant variation and some banks are quite low on variable compensation. Old private sector banks are only halfway there.

Public sector banks are in urgent need to introduce credible performance–linked compensation. The current spend on variable pay is almost negligible. Existing guidelines from ministry of finance limit variable compensation to one percent of PAT, which is roughly one percent of total employee costs. Banks typically find it difficult to distribute even up to this low prescribed

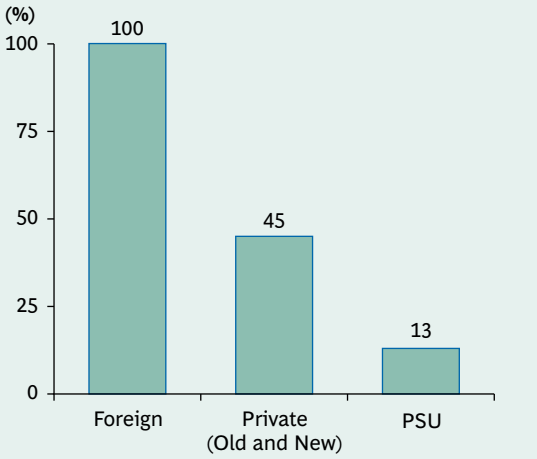
Exhibit 5d. Next generation measurement systems

Measurement systems act as foundation for high performance organization design

Organization capabilities

- ☑ **Access product level and SBU level net profitability by applying MFTP[1]**
- ☑ **Management accounting distinct from financial accounting**
- ☑ **Allocate capital to business units and use for performance measurement**
- ☑ **Executive performance assessment linked to targeted productivity metrics**
- ☑ **Dedicated unit for continuous process quality measurement and improvement**

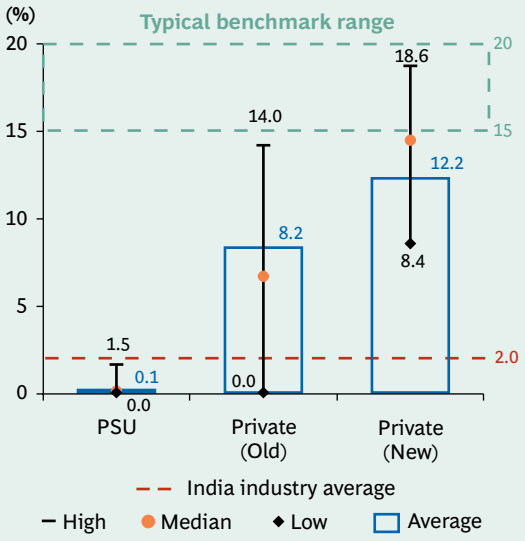
Percentage of banks with all five ticks (✓)



Sources: FIBAC Productivity Survey 2011; BCG analysis.
Note: As claimed by banks in FIBAC Productivity Survey 2011.
[1]MFTP = Matched Funds Transfer Pricing.

Exhibit 5e. Performance linked pay

Variable pay as a percentage of total employee is only 2%



Sources: FIBAC Productivity Survey 2011; BCG analysis.
Note: The total cost attributable to the employees includes fixed salary, bonus, pension and gratuity.

limit. PSU banks should expeditiously deploy systems that can facilitate differentiation among employees based on performance, and award variable compensation to staff. The Government of India should facilitate higher levels of variable compensation in PSU banks.

Adopt Alternate Manpower Solutions: Critical for Low Cost Banking

On an average, outsourced manpower costs and captive manpower subsidiary costs account for about two percent of total manpower costs of banks in India. This ratio is higher at 5–10 percent for new private sector banks and foreign banks. Such solutions provide a way for the banks to deploy manpower at a cost much lower than on their own books. So far, such solutions have been adopted for feet–on–street sales staff. We believe that in future, such solutions will be required on a larger scale to create low–cost banking business models for financial inclusion. Low–cost banking models require manpower at substantially lower costs (10–20 percent of current per head costs). Keeping manpower at two vastly different compensation levels in the same legal entity creates its own set of management issues.

Bad Debt Management

Proactive, Pre–emptive, and Preventive

"Avarice and usury and precaution must be our Gods for a little longer still"

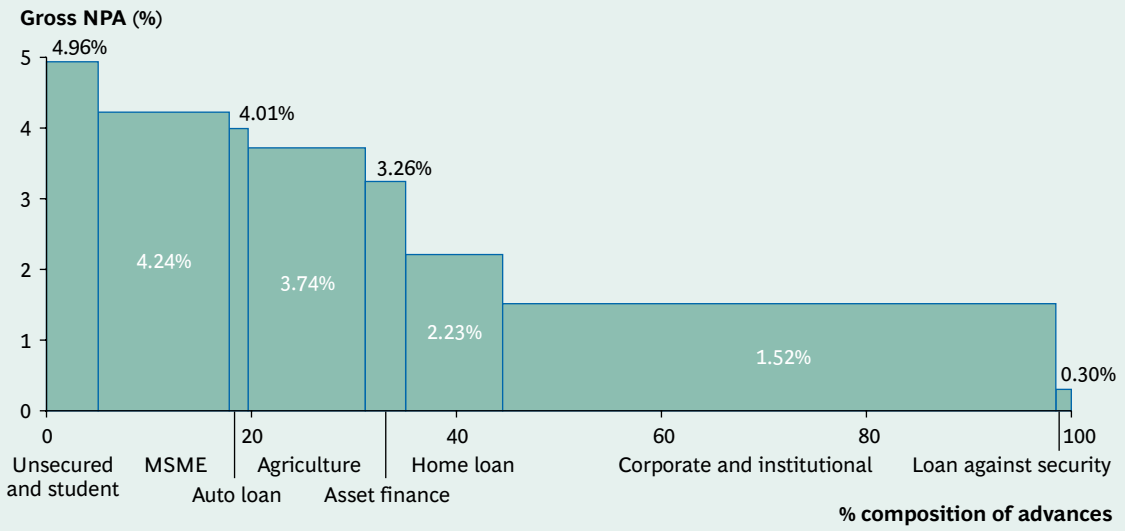
— John Maynard Keynes

The gross NPA ratio in the Indian banking industry came down from more than 10 percent in the early part of the last decade to less than 2.5 percent by the end of the decade. As illustrated in Exhibit 1a, the bad debt charge to the P&L of the Indian banking sector is in the lower half of the spectrum amongst comparable economies. Unlike many developed economies, this charge has not increased significantly post crisis. Control over bad debt indeed appears to be one of key successes of the industry and its regulators. A disaggregated and closer examination of bad debt figures, however, is not so comforting.

Address Weaknesses Where they Hurt Most

Exhibit 6a illustrates the profile of bad debt in the books of Indian commercial banks as on March 31, 2011. Corporate and institutional credit, which accounts for more than 50 percent of the credit, is the lowest risk segment followed closely by home loans. Unsecured

Exhibit 6a. NPA profile of India Banking
Category wise NPA



Sources: FICCI IBA Productivity Survey 2011; BCG analysis.
Note: Asset Finance = Construction equipment, commercial vehicles; Loan against security = Loan against jewels, deposits, shares, etc.

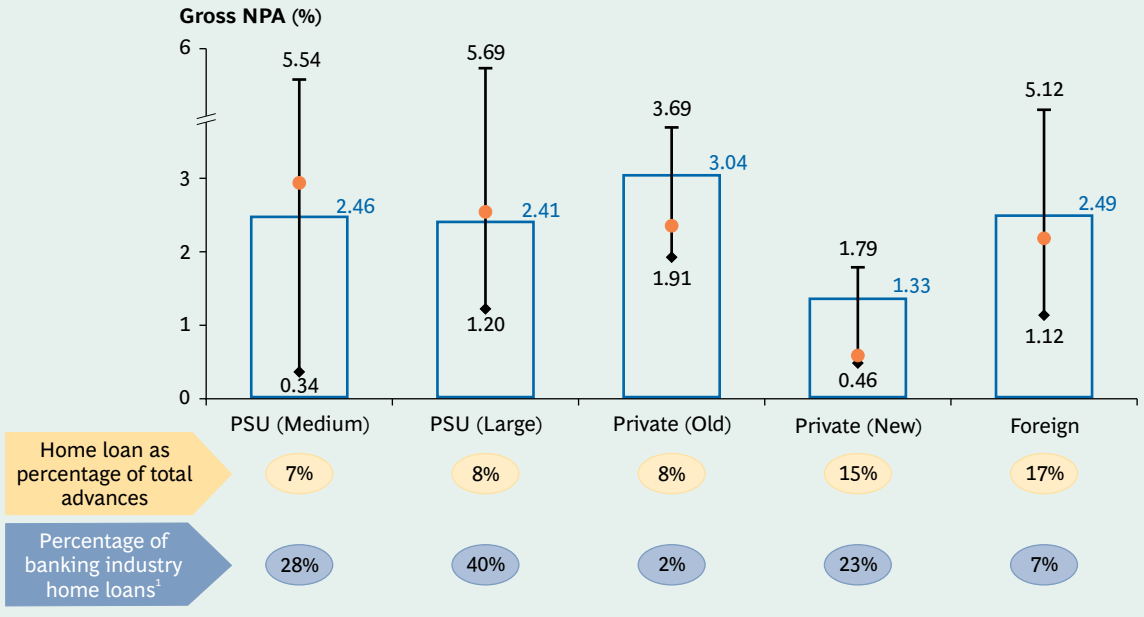
credit is understandably the most risky segment with, on an average, 5 percent gross NPA outstanding. MSME credit at 4.24 percent and agriculture credit at 3.61 percent stand out as large business segments with high risks. No wonder banks shy away from these high–priority sectors of the economy.

In a more evolved financial system, corporate and institutional credit would get "disintermediated" as corporate clients tap wholesale debt markets directly for lower borrowing costs. Banks would then have to focus on MSME, retail, and agriculture credit and learn to manage the bad debt in these important segments. Not so yet in India. The Indian wholesale debt market is quite shallow and the corporate sector depends heavily on bank finance for credit needs. For most banks, corporate credit is the primary driver of growth on the asset side and retail, MSME and agriculture function only as a "top up" or are seen as mandatory obligations to be fulfilled. Consequently, in India, MSME credit grows slowest amongst all segments and the banking industry is perennially short of agriculture credit targets. Bad debt levels continue to be high in these segments because of lack of innovation in credit delivery.

Build Risk Skills in the Public Sector

Exhibit 6b and 6c illustrate the position of bad debt on the balance sheets of banks in different segments in home loans and MSME advances, respectively. MSME credit is a traditional segment that has been in existence for decades and is typically considered risky. Home loan is a new area of credit that has become significant only in the last decade and is typically considered safe. As one would expect, there is a wide range in the bad debt experience of banks. Private sector performance is in a narrow band. Public sector performance is highly disbursed in a wide band. A number of public sector banks have very high levels of NPA in home loan, which is conventionally considered one of the safest loan categories. This could be because of the fact that exposure to home loans of such banks is smaller than the critical size required to acquire minimum expertise and create a viable business model. Home loan is a new product for most public sector banks and needs a special business model and risk system to manage it. It is interesting that the new private sector, which is dominant in home loan, has, on an average, done better in risk management so far. New private sector initiated the home loan business

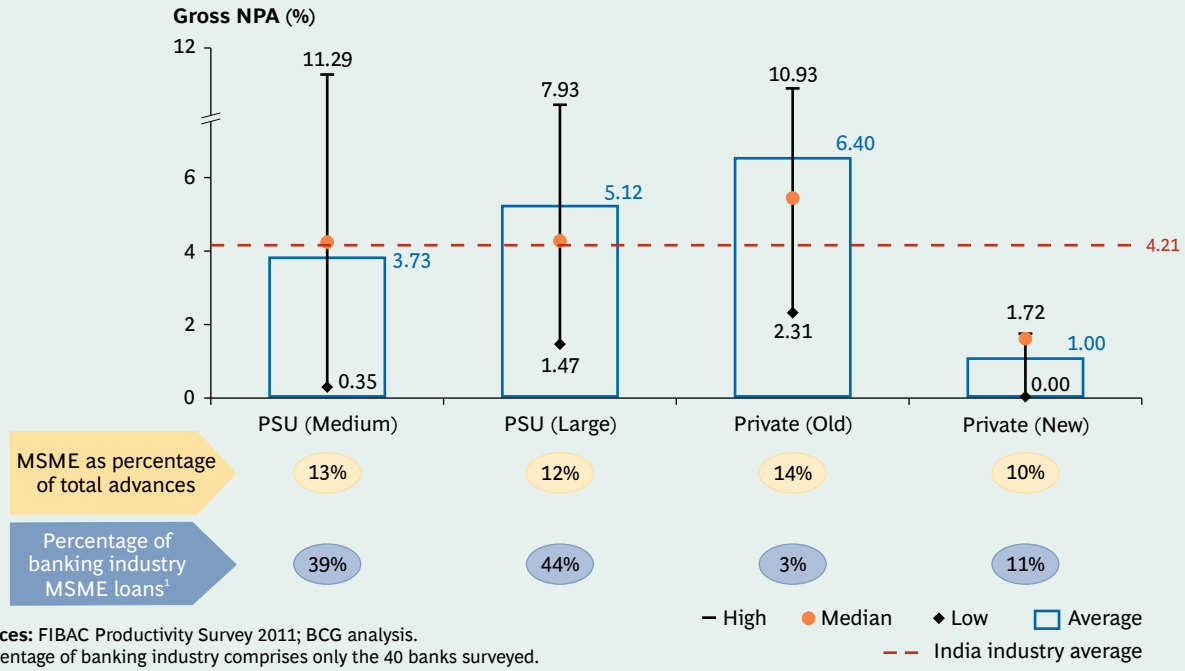
Exhibit 6b. Wide range in NPA performance
Gross NPA in home loans



Sources: FIBAC Productivity Survey 2011; BCG analysis.
[1]Percentage of banking industry comprises only the 40 banks surveyed.

Exhibit 6c. Wide range in NPA performance

Gross NPA in MSME advances



Sources: FIBAC Productivity Survey 2011; BCG analysis.
[1]Percentage of banking industry comprises only the 40 banks surveyed.

with a customized business model and risk management practices. The same is not true for the old private sector where bad debt levels are high for all players in a narrow band. The story on MSME is different. The public sector is not a marginal but the dominant player here and has been doing this business for years. New private sector has stayed small, contained its exposure, and cherry–picked good risk. Old private sector appears to be the worst hit. Public sector performance spans the whole range from best to worst. There is learning to be shared between public sector banks. Risk management is a capability that comes with experience. The public sector will lose a lot of experienced staff because of retirements in the next five years. It is thus poised for further weakening of its risk management capacity.

In the foreseeable future, it is conceivable that public sector banks will continue to finance the lion's share of priority sector segments like MSME and agriculture. It is also conceivable that the public sector will continue to increase its exposure to new credit segments like mortgages and retail lending. It is imperative that it builds next–generation systems and business models for risk management on a top priority basis.

Adopt New Paradigm for Risk Management

Risk management is a core capability for banks. To retain the right to participate profitably in the lending business, banks have to continually upgrade their business models and systems. Lending is made further complex with the rapid pace of change in the Indian economy. New customer segments are emerging, new products are being designed, and the legal and regulatory framework is being fine–tuned. Banks have to invest in five areas to retain their edge over their borrowers and get their money back.

Operating model

The operating model for the lending business has to vary quite significantly by product lines. This is illustrated in Exhibit 6d. Retail lending needs centralization of processing, collections, and operations. Credit decisions have to be rule–based. Credit scoring has to be based on credit history and customer data. Collections have to be algorithmic and structured. SME lending needs close interaction, personal knowledge and follow–up with the borrowers. A borrower's intent to repay is crucial to know

Exhibit 6d. NPA management: proactive, pre–emptive, and preventive
Segmented strategy by business area

Retail finance and asset finance	MSME	Rural and agriculture	Corporate and infrastructure
• Industrialised model, segregation of origination and collection	• Cluster based surrogate measures	• Unity in origination and collection	• Industry expertise and technical know how
• Credit information bureau	• Asset based lending techniques	• Technical knowhow of livelihood	• Financial analysis and projections
• Analytics	• Information services	• Community due diligence	• Deal structuring, risk mitigation and design of covenants
• Prudent norms on LTV[1] and LTI[2]	• Factoring services	• Social collateral	• Sector–wise portfolio management
• Algorithmic response to default	• Segmented response on basis of borrower intent	• Aligning repayment schedule and collection strategy to income pattern	
• Programmed alerts prior to due dates	• Local centralization of credit skills		
	• Close physical monitoring of business for early detection of business stress		

Source: BCG analysis.
[1]LTV – Loan to Value.
[2]LTI – Loan to Income.

and act upon. Surrogate measures have to be used for credit assessment. Processing can be centralized at the local level. Rural and agricultural credit require unity in origination and collection, high level of community knowledge, appreciation of livelihoods and cash–flow patterns of various rural professions, and use of social collateral. Large corporate credit requires high–quality financial analytics, projections, industry expertise, financial deal structuring, and contract design. It is clear that everything cannot happen in a traditional branch setup. Structures, roles, and processes have to vary.

Minimum critical size

Risk management is an experiential capability that develops in employees with time and experience. A minimum size of business at the country level and at local level is crucial to provide the staff with the critical experience to manage risk. Banks have to decide what products not to offer till they have intent to participate at a critical size.

We observed in the survey that NPA levels typically fall with increase in market share till they reach a critical size of 5–10 percent depending upon product.

Technical expertise

Technical aspects of risk management vary by product segment and employees have to be assigned and trained specifically for each product.

Experience

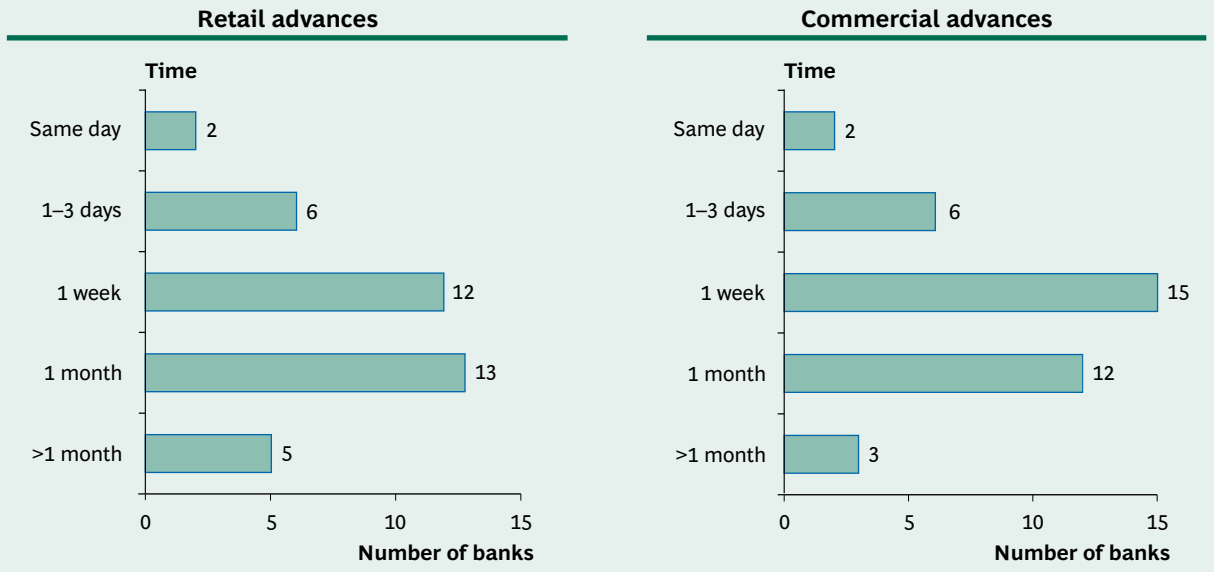
Conventional training is necessary but not sufficient for risk management. Risk management continues to be an art that requires personal experience and time. Training has to be complemented with "mentorship" and "apprenticeship" for the juniors. It is important to create career tracks and build cadres of employees who can envisage spending their whole career honing their credit and risk skills to perfection over time.

Discipline in processes, supported by technology

Day–to–day process discipline is the underlying foundation on which the expertise can be executed. The primary issue in risk management is the speed with which banks respond on noticing the first signs of problems and whether decisions to foreclose are taken on time or are delayed on false hopes. Exhibit 6e highlights this weakness in Indian banking, based on responses to

Exhibit 6e. Wide variance in response time to default

Number of days taken to reach out to customers post default



Sources: FIBAC Productivity Survey 2011; BCG analysis.

the productivity benchmarking survey of the 40 largest banks. Exhibit 6e illustrates the time that banks claim they take in reaching out to a customer who has defaulted / missed a payment. In retail loans, about 50 percent of the banks in the sample claim to reach out to the defaulting customer in a month or more, while this is something that should be done on the same day. For commercial credit, the response time is marginally better but hardly where it should be.

For the public sector, the challenge of transformation is higher because it has to change the old business model and introduce new expertise, business model, and processes. The road to excellence in risk management is a mandatory journey for banks and speed is of the essence.

Imperatives for Government and RBI

Out of the five areas of productivity excellence, bad debt management is the one where the government and the regulator have as much of a role as the banks. Recovery happens within a social, legal, and regulatory framework. The government and the RBI have their roles cut out for them to create an enabling and facilitative environment for better risk management by banks.

Key imperatives for the Government are:

- The single–most powerful enabler for bad debt management is the availability of credible collateral, certainty of its valuation, and ease of its repossession in the event of default. The government has to play a crucial role in all of this.
- Real estate is by far the biggest collateral for banks. The real estate market needs regulation and reforms to ensure transparent valuation of the property to be used as collateral and also to ensure speedy disposal of property. Easily available and well–documented title deeds for property in urban centres will increase the flow of credit to SME and small entrepreneurs and also help banks manage risks better. Property rights for slum dwellers could unleash credit flow to them.
- Computerization of land records will facilitate agricultural lending by making the process of mortgaging agricultural land fast and transparent.

- Speed and certainty of contract enforcement have a direct impact on a bank's ability and willingness to take risks. The introduction of the SARFAESI Act improved the quality of bad debt management in banks significantly. However, the speed of decisions — especially those involving court procedures — has a long way to go.

- As a primary owner of public sector banks, the government has a responsibility to push for faster capacity building and operating model transformation at public sector banks. Induction and grooming of new talent, as a large number of experienced staff retires, is the first step. However, as highlighted above, credit risk is not just a matter of classroom training. It is acquired through on–the–job hands–on experience over time.

  - The government should insist on well–defined career tracks and grooming through job rotations for personnel having an aptitude for credit risk.

  - To ensure that risk management is on top of the agenda, the government should ensure that selections for top jobs at public sector banks lays emphasis on appreciation of risk management.

  - Metrics for performance assessment at the banks have to move to risk–adjusted measures like Return On Risk Adjusted Capital (RORAC) so that the top management is sensitized to the centrality of risk in decision making. The current vigilance–inspired accountability framework encourages people to go by the book even if it is against business judgment. A new system of performance accountability has to celebrate quality of business decisions.

- The government should facilitate the creation of a dedicated institute for risk management for capability creation in the public sector banking industry.

Key imperative for the RBI are:

- Set a higher aspiration for Indian banks: The RBI's insistence on prudential norms for asset recognition and adoption of Basel norms has been instrumental in pushing the quality of risk management in Indian banking to a whole new level. Improvement in the quality of Indian banks' books is shining evidence of this. The RBI has to now set its sights on a higher aspiration for Indian banks on risk management — even as the rest of the world is still unclear about the implications of the banking crisis.

- Create a centre for excellence in risk management: Compliance with Basel III could hardly be a worthy goal for the Indian banking industry. After all, many Basel II compliant banks quickly succumbed to the banking crisis. The RBI, vindicated by the performance of Indian banks through the global banking crisis, has to assume leadership in defining the new Indian paradigm for risk management in post crisis banking. Broad contours of such a new paradigm could be ideas that do not find sufficient attention in the Basel framework but have been found to be crucial when crisis hits.

  - Emphasis on ex–ante assessment of risk as against ex–post analysis.

  - Emphasis on detection of risk through multiple signaling channels.

  - Emphasis on the role of appropriate operating models for effective risk management in different product classes.

  - Emphasis on expertise building with added attention towards retention of experience and institutional memory in the organizations.

  - New–generation performance measurement metrics to ensure that top management incentives are aligned to risk management.

To give shape to and propagate this new paradigm, the RBI could set up a dedicated centre of excellence in risk management as a think tank, research institute, and senior management training facility.

- Rapid acceleration in adoption of credit information bureaus: The RBI should facilitate — if required by regulatory fiat — faster build out of retail, rural and MSME credit information bureaus in the country. The systemic value of such an intervention is large enough to justify regulatory coercion. With the rapid rollout of Aadhar, the quality of information bureaus (and quality of risk management in Indian banking) can be enhanced by an order of magnitude.

Note to the Reader

About the Authors

Saurabh Tripathi is a Partner & Director in the Mumbai office of The Boston Consulting Group. Bharat Poddar is a Principal in the Mumbai office of The Boston Consulting Group.

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 7163
shah.alpesh@bcg.com

Ashish Garg
BCG New Delhi
+91 124 459 7123
garg.ashish@bcg.com

Bharat Poddar
BCG Mumbai
+91 22 6749 7145
poddar.bharat@bcg.com

Janmejaya Sinha
BCG Mumbai
+91 22 6749 7003
sinha.janmejaya@bcg.com

Neeraj Aggarwal
BCG New Delhi
+91 124 459 7078
aggarwal.neeraj@bcg.com

Pranay Mehrotra
BCG Mumbai
+91 22 6749 7143
mehrotra.pranay@bcg.com

Ruchin Goyal
BCG Mumbai
+91 22 6749 7083
goyal.ruchin@bcg.com

Saurabh Tripathi
BCG Mumbai
+91 22 6749 7013
tripathi.saurabh@bcg.com

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