International Journal of Business and Management Invention
ISSN (Online): 2319 – 8028, ISSN (Print): 2319 – 801X
*www.ijbmi.org Volume 2 Issue 2 ‖ February. 2013‖ PP.*55-59

Infrastructure development as growth driver for Indian Banks

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Why this topic

Indian banking system has received focused attention from the world recently. The focus has been because of two reasons primarily i.e.

a) How has this institution survived the onslaught of the global crisis twice in the recent past and

b) What would the trajectory of this important sector post under 8 % growth rates as seen in the last two quarters?

Enough discussion has happened about the former but very few have shed light on the vision plan of the later. In India, we do not have the habit of hearing many a banker having a long term (read atleast 5 years) vision of their respective bank. That makes the topic all the more critical; how is it going to survive the onslaught of the low-growth economy coupled with the socio-political crisis that is brewing in the country (read the unstable times).

State of Banking Industry

After all the banking industry of the nation stands at INR 64 trillion (USD 1.17 trillion) and it has seen impressive growth in the last few years as is clearly visible in **Exhibit 1**.

	Public Bank		CAGR (%)	Private Bank		CAGR (%)	Foreign Bank		CAGR (%)
	2006-07	2011-12		2006-07	2011-12		2006-07	2011-12	
Deposits (Rs. Cr.)	1994200	4372985	21.7	551987	1002759	16.1	150750	240689	12.4
Investments (Rs. Cr.)	664856	1328534	18.9	214655	422020	18.4	71471	165499	23.4
Advances (Rs. Cr.)	1440146	3305632	23.1	414751	797534	17.8	126339	195539	11.5
Int. income (Rs. Cr.)	164185	366318	22.2	49567	96827	18.2	17924	28520	12.3
Int. expended (Rs. Cr.)	101960	231153	22.7	32856	57115	14.8	7603	10622	8.7
Net int. income (Rs. Cr.)	62225	135165	21.4	16711	39712	24.2	10321	17898	14.8
Business per employee (Rs. Lakh)	471.18	1013.63	21.1	695.23	823.26	4.3	974.77	1559.74	12.5
Profit per employee (Rs. Lakh)	2.76	5.93	21.1	4.65	8.1	14.9	16.13	27.59	14.4

Source: RBI

Exhibit1: Five years growth story of Indian banks

As is clearly visible, CAGR across deposits, investments, advances and net income is very healthy but clearly different in the three different categories of banks. If we look at 5 years historical performance of different types of players in the banking industry, public sector bank has grown its deposits, advances and business per employee by the highest rate – 21.7%, 23% and 21.1% respectively. As far as net interest income is concerned, private banks are ahead in the race by reporting 24.2% growth, followed by pubic banks (21.4%) and then by foreign banks (14.8%). Though the growth in the business per employee and profit per employee has been the highest for public sector banks, in absolute terms, foreign banks have the highest business per employee as well as profit per employee. Whatever may be the internal spread of the figures between the types of banks in the nation, one thing is for sure that it would be difficult to maintain the growth rate.

Few points to note in this regard

a. What are the avenues for growth or sustenance of the same rate levels for the banks?
b. Consumer story has been there for some time and the changes are already built in to the entire financial system of the nation and hence that sectors' contribution has already figured into the banking system too. What could be the next story that could fillip up the momentum levels?
c. Because of various reasons, many of them better known to the regulators more number of players are expected to dot the already seemingly crowded banking space.
d. In India, banking system has already been treated as a benchmark of the industry. Government has been dolling out sufficient amount of money even to the poorly fairing banks to keep the entire banking system afloat. It knows very well that a small iota of weakness can just trigger an international onslaught of raised fingers particularly when all so-called successful formulae of the west have gone for rot.

There has to be a way out of this expectation and the scenario. The only story that stands up to all the points is ***infrastructure***. In the next course of the paper, we shall discuss the rationale by which infrastructure can stand up as the major cause for successfully running the banking show for many years to come.

Before we delve into the details, here is a small peek into the figures that we are discussing. RBI has already envisaged this glaring gap and the challenge which lies in front of all concerned in the country to help finance the great gap. **Table 1** clearly shows the investment figures in the segment from 2007-08 to 2011-12. One would observe that while the GDP growth rate is envisaged at 52.41%, the total investment growth is pegged at 123% and within that the bulk coming from the private sector investment. We may place another inference here that government's direct spending is not in line with the private investment. It is a different story that government has a majority stake across many of the leading public sector banks.

Table 1: Revised Projected Investment on Infrastructure								
(Rs. crore at 2006-07 prices)								
	Tenth Plan	**Aug-07**	**Sep-08**	**Oct-09**	**Nov-10**	**Dec-11**	**Eleventh Plan**	**% Increase between the Plans**
GDP	**1,78,40,877**	**47,17,187**	**50,03,545**	**55,63,800**	**57,92,904**	**63,14,265**	**2,71,91,700**	**52.41**
Public Investment	**6,94,006**	**1,99,539**	**2,38,054**	**2,62,963**	**2,90,832**	**3,19,904**	**13,11,293**	**88.94**
Private Investment	**2,25,220**	**1,04,268**	**1,21,138**	**1,39,866**	**1,69,227**	**2,08,413**	**7,42,912**	**229.86**
Total	**9,19,225**	**3,03,807**	**3,59,192**	**4,02,829**	**4,60,059**	**5,28,316**	**20,54,205**	**123.47**
Investment as percentage of GDP								
Public Investment	**3.89**	**4.23**	**4.76**	**4.9**	**5.02**	**5.07**	**4.82**	
Private Investment	**1.26**	**2.21**	**2.42**	**2.61**	**2.92**	**3.3**	**2.73**	
Total	**5.15**	**6.44**	**7.18**	**7.51**	**7.94**	**8.37**	**7.55**	
Source: Mid-Term Appraisal of the Eleventh Five Year Plan, Planning Commission.								

Let us also go through the year-on-year projection for the Twelfth Five Year Plan of infrastructure as per figures of RBI and Planning Commission. **Table 2** gives a fair idea of this spread vis-à-vis the GDP projections.

Table 2: Projected Investment in Infrastructure during the Twelfth Five Year Plan						
(Rs. crore at 2006-07 prices)						
	2012-13	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**Twelfth Plan**
GDP	**68,82,549**	**75,01,978**	**81,77,156**	**89,13,100**	**97,15,280**	**4,11,90,064**
Rate of Growth of GDP	**9.00**	**9.00**	**9.00**	**9.00**	**9.00**	**9.00**
Infrastructure Investment as per cent of GDP	**9.00**	**9.50**	**9.90**	**10.30**	**10.70**	**9.95**
Infrastructure Investment	**6,19,429**	**7,12,688**	**8,09,538**	**9,18,049**	**10,39,535**	**40,99,240**
Source: Mid-Term Appraisal of the Eleventh Five Year Plan, Planning Commission.						

Though banks are not the only players in the entire game, they do have the most important role to play as they will be present in every project either directly or indirectly. NBFCs, insurance companies and ECBs have to necessarily route transactions through the bank route. Let's not forget that lending is not the only role of banks; being a conduit also beckons and means great for the infrastructure story. So banks would have the transactional handling of their monies at any point of time. Now with the advancement of technology, the speed of monies getting transacted increases but whatever it may be, banks have the most important role in the entire story.

While we have shared the projection of the total investments in infrastructure, let us also check out the projected breakup of the sources of these investments. **Table 3** provides the same.

Table 3: RBI's financial projections on infrastructure

Funding Gap in Infrastructure Finance during 2010-11 and 2011-12			
(Rs.crore)			
Source of Funds	**Estimated Requirement***	**Estimated Availability#**	**Funding Gap**
Commercial Banks	**2,67,480**	**2,02,027**	**1,25,685**
NBFCs@	**1,24,699**	**1,00,651**	
Insurance Companies	**52,046**	**42,330**	
ECBs	**76,984**	**50,515**	
Total Debt Funds	**5,21,208**	**3,95,523**	
Equity$	**1,86,456**	**1,84,571**	**1,885**
Total	**7,07,664**	**5,80,094**	**1,27,570**
As per existing pattern, # As per trends.@ Including IIFCL. $ Including FDI. Source: Planning Commission (2010), Conference on 'Building Infrastructure: Challenges and Opportunities – Financing of Infrastructure', March 2010.			

The Infrastructure Story

Some statements on Macro-perspective:

a) Investments in infrastructure totaling $240 billion between 2007 and 2010 have already been made under India's 11th Five-Year Plan.

b) The inside story is a bit bleak one. It's a known fact that the infrastructure story revolves around for important and inter-dependent factors i.e. creation of adequate projects through tenders, uptake of the same by the private players and cash contractors, financial closure and start of the project and finally the execution of the projects on-time and within budgets. As per the figures spoken about the Eleventh Plan, only power sector seems to be on track by achieving 100% of the planned capacity. The airport sector stands at 75% and that of roads stands at 50% correspondingly.

c) The infrastructure sector was one of the thrust areas in the Union Budget 2012-13, as Finance Minister Mr Pranab Mukherjee announced a slew of proposals, including allowing financial institutions to raise about INR 60,000 crore (US$ 12 billion) from tax-free bonds and envisaging a greater private participation.

d) India has 12 major ports, 5th largest electricity generation capacity in the world, 454 airports & airstrips and fourth largest rail network in the world.

e) As per a study made by research agency Preqin, India is attracting the highest number of unlisted, closed-end funds that focus on a single country, making it the most preferred choice among emerging markets. India is expected to require around US$ 1 trillion worth of infrastructure investment over the next five years.

f) The Planning Commission has projected that investment in infrastructure would almost double at US$ 1,025 billion in the Twelfth Five Year Plan (2012-17), compared to US$ 514 billion in the Eleventh Plan. Of the US$ 1,025 billion, 50 per cent is expected to come from private sector, whose investment has been 36 per cent in the Eleventh Plan.

Industry specific viewpoints

a. Power

The power ministry has set a target for adding 76,000 MW of electricity capacity in the 12th Plan (2012-17) and 93,000 MW in the 13th Five-Year Plan (2017-2022). The Working Group on Power for formulation of the 12th Five Year Plan has estimated total fund requirement of INR 13,72,580 crore for the power sector. During the Twelfth Five Year Plan, the main sources of financing are commercial banks, public financial institutions, dedicated infrastructure/power finance institutions, insurance companies, overseas markets, bilateral/multilateral credit, bond markets and equity markets.

FDI inflows have been to the tune of USD 10 Mn during the period April-May 2012 according to DIPP. Prominent policies like National Electricity Policy, Ultra Mega Power Project Policy, Mega Power Policy, CERC Policy and tariff Policy are bound to make the sector more attractive.

As per McKinsey's projections, the sector is expected to see potential revenue generation of USD 4.2-4.9 Mn. between the period 2010-14. *For banks, besides project finance, the opportunities are in cash management, forex, letter of credits and trade finance management activities like receivable discounting.*

b. Roads

With 4.2 Mn kilometers of roadways, India can boast of having the second largest road network. However the tragedy is that 30% of national highways are still single laned and 53% are double laned. The opportunity for investment is based on the up gradation project of 3700 kms of national highways under the National Highways Interconnectivity Improvement Project (NHIIP, project of USD 4.26 Bn), National Highways Development Program (NHDP, projected investment of USD 50 Bn) and the Bharat Nirman Program. The three segments of roadways namely national highways, state highways and rural roads represent a cumulative revenue pool of USD 2.4-2.8 Bn between the period 2010-14. *For banks, besides project finance, the opportunities are in toll-cash management.*

c. Ports

Almost 95% of the total international trade by volume is routed through maritime method in India. As per the present utilisation statistics (2011-12), the 12 major and 200 non-major ports handled 971 Mn tonnes while the capacity was 1247.5 Mn tonnes. It is envisaged that by 2016-17, the total capacity should have been elevated to 2301 Mn tonnes (as per the 12th Five Year Plan document). 3 primary sub-sectors combined namely major ports, minor ports and connectivity projects represent a cumulative revenue pool of USD 650-720 Mn between 2010-14. *For banks, besides project finance, the opportunities lie in e-handling of cesses through Port Community System, forex transactions and non-fund limits.*

Besides these major sectors, we also have investment opportunities in railways, Aviation and Real estate.

Major Infrastructure Sectors	Investment Plans	Revenue Projections
Road	USD 100 Mn. for 12th Five Year Plan	USD 2.4-2.8 Bn for 2010-14
Port	INR 73794 Cr. for 12th Five Year Plan	USD 650-720 Mn for 2010-14
Power	INR 13.72 Lac crores for 12th Five Year Plan	USD 4.2-4.9 Bn for 2010-14
Railways	2012-13 Plan outlay as INR 60100 Cr.	
Airports	USD 30 Bn on airports in the next 10 years	

Banking requirement for serving this story

Meeting these investment needs could create annual wholesale banking revenues of \$6 billion to \$7 billion across lending, debt syndication, capital raising, and secondary markets. But banks must be willing to innovate, potentially becoming active developers in addition to operating through third parties, and they must also embrace more sophisticated products, such as project financing, through a mix of syndicated lending in foreign currencies, nontraditional structured-trade-finance instruments, and securitization of cash flows.

The scope for banks is not just in lending (fund based as well as non-fund based) but a variety of other activities like syndication, equity capital raising, advisory services and transactional banking.

Major Infrastructure Sectors	Avenues for Banks
Road	Project financing, toll-cash management.
Port	Project financing, PCS management, Forex transactions, LC handling
Power	Project financing, bill discounting, Forex transactions, revenue collection
Railways	LC and BG handling in PPP projects, Forex transactions, revenue management

Challenges

a) Managing asset-liability mismatches will be a key challenge that will require institutions to broaden the sources of funds for projects beyond bank financing. Indian banks typically have their base on short term liability and the investment in the infrastructure is of a long-term in nature.

b) The entire world is watching because the figures envisaged in the Eleventh Plan stands at 28% of the total from emerging economies and is second only to China.
c) Most of the infrastructure burden has been shared by the government (through banks) in the past. With the fiscal burden increasing, the challenge for the government would be to balance the social spending and the long term payment obligations.
d) Bankers need to structure business models so as to get high returns on the same.
e) A McKinsey survey of Indian project financing has shown that the developers typically tend to focus and use the dominant bankers' services more than the others resulting in the usage of smaller banks only for financing. This factor might stunt the growth of infrastructure in terms of lack of funds / transactional services over a period of time.

SUGGESTIVE POINTS IN CONCLUSION

a) This cannot be a particular bank or a group of banks story. It has to be a banking story if the banks have to make the best of it. All the banks have to collaborate to make the best of it by being transparent and seeing the long term benefit. Partnership amongst major banks can showcase a strong message to all the players in the market.
b) Successful implementation would require development of certain innovative products so as to leverage the best from the situation and so away with the regular monotonous offering. The risk has to be borne with the possible dimension and the futuristic earnings of any specific infrastructure project.
c) The banks also have to lobby with the regulators for changing few rules if required so during the development of a particular model for a infrastructure project or any infrastructure industry as a whole. If required government through its specified ministry should also be corroborated if deemed fit.
d) Typical banking will become more global as Indian companies would expand their international operations and new regulations facilitate international capital raising. Foreign banks typically have a strong position and tend to dominate these product markets because of their strong international balance sheets and better credit ratings. But given growing demand from Indian corporates for access to non-rupee funds both in India (in the form of external commercial borrowings) and globally, Indian banks can respond by establishing a presence in key global financial centers viz Shanghai, Singapore, New York, London and by building appropriate funding and distribution capabilities.

SILVER LINING

a) Scope for External Commercial Borrowings has reduced post European crisis.
b) The Return on Equity (RoE) expected in terms of investment for the banks can scale upto 20-30%

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