FINANCING - THE CHANGING PARADIGM IN INDIA

UDAY KOTAK

2003

Published by

THE A.D. SHROFF MEMORIAL TRUST

Peninsula House, 235, Dr. D. N. Road,

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OBJECTIVES

(i) Publication of one or more books in English, Hindi and regional languages on some of the great builders of Indian economy aimed primarily at educating the younger generation in high standards of building the national economy as practised by those great entrepreneurs and placing the example of their lives for emulation by India's youth.

(ii) Organising one or more public lectures annually on subjects, which were of interest to the late Mr. A. D. Shroff, namely, banking, insurance, and industrial finance, the subject to be chosen in rotation, and the lectures to be delivered by persons eminent in these fields.

(iii) Awarding annual scholarship or scholarships to outstanding student or students in the field of management.

(iv) Instituting a prize to be known as The A. D. Shroff Memorial Prize for the student standing first in Banking at the Sydenham College of Commerce and Economics, Mumbai.

(v) Doing all such acts, matters and things as are incidental or conducive to the attainment of the above aims or objects or any one or more of them, and

(vi) Without prejudice to the above charitable objects or any of them, the TRUSTEES shall have the power to spend, utilise and apply the net income and profits of the TRUST FUND for the TRUST FUND for the charitable object of education or such other objects of general public utility not involving the carrying on of any activity for profit as the Trustees may think proper. It being the intention of the SETTLOR that the income and/or corpus of the Trust Fund shall be utilised for all or any of the aforesaid charitable objects without any distinction as to caste, creed, or religion.

A. D. Shroff
(1899-1965)

A. D. Shroff's achievements in the field of business, industry and finance were many and varied. A large number of enterprises owe their origin and development to him. As an economist, his predictions have proved right over the years. Through the Forum of Free Enterprise, which he founded in 1956, as a non-political, educative organisation, he sought to educate the public on economic affairs. It was his firm conviction that a well-informed citizenry is the foundation of an enduring democracy.

George Woods, former President of the World Bank, paid the following tributes to A.D. Shroff :

"In every age and in every society men must express anew their faith in the infinite possibilities of the human individual when he has freedom to develop his creative talents. For this is in large part how the message of freedom is passed from generation to generation. A. D. Shroff spoke eloquently in a great tradition, and thanks to him we can be sure that other great men of India will continue to speak this message in the unknown context of our future problems."

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ACKNOWLEDGEMENT

The Trust is grateful to Bank of India and particularly its then Chairman & Managing Director, Mr. K. V. Krishnamurthy, for their kind gesture in sponsoring the Annual Public Lecture delivered by Mr. Uday Kotak on 11th February 2003 and subsequently publication of this booklet for public education.

Minoo R. Shroff
Chairman & Managing Trustee
The A. D. Shroff Memorial Trust

INTRODUCTION

In the Annual Public Lecture series which the A. D. Shroff Memorial Trust conducts in honour of the late A. D. Shroff, we have pleasure in publishing the text of the lecture given by Mr. Uday Kotak on "Financing – The Changing paradigm in India".

The late Mr. Shroff was recognized as an authority on commercial and industrial banking in his heyday. His notable contribution in this area was the Report of the Committee on Finance for the Private Sector appointed by the Reserve Bank of India in 1954 and of which he was the Chairman. This Report led to the formation of various financial institutions like ICICI, IDBI and UTI. He played a significant role in the promotion of and initial development of ICICI. It is, therefore, proper and in the fitness of things that a young dynamic and imaginative banker like Mr. Uday Kotak was invited to deliver the A. D. Shroff Memorial Lecture.

Mr. Uday Kotak is a dynamic young banker and has made his mark in the banking world in the last decade. He has recently promoted the Kotak Mahindra Bank which he is heading. His views on the emerging scenario in the banking industry is very pertinent. He has stressed that the traditional approach to banking has to give way to more contemporary global concepts. He has rightly placed the thrust on anticipating the need of the customer and hence adopting a proactive approach. His observations on the need to give a go by to the earlier compartmentalization of banking between Industrial Finance, Banking and Insurance are indeed refreshing.

I am sure that the incisive observations made by Mr. Kotak in his lecture will evoke fresh thinking among bankers and other serious students of the subject.

We are very grateful to the Bank of India, and particularly to Mr.

K. V. Krishnamurthy, the then Chairman & Managing Director, for sponsoring the lecture which was delivered on 11th February 2003 and subsequently the publication of this booklet for public education.

Minoo R. Shroff
Chairman & Managing Trustee
The A. D. Shroff Memorial Trust

Mumbai,
6th August, 2003

FINANCING - THE CHANGING PARADIGM IN INDIA

by
Uday Kotak*

I am indeed honoured to be speaking here on the occasion of the A. D. Shroff Memorial Trust lecture. I remember my days as a college student at Sydenham College, when I used to often come and attend these lectures once a year, and it always used to be a learning experience for me. Therefore in a sense, it's a delight and privilege for me to be given the opportunity to speak here. The subject for today is "*Paradigm shifts in the financial sector or in the business of financing*". I would like to step back for a moment and first talk about paradigm shifts which all of us experience in the real world before I come to the business of finance.

I remember in my childhood, that was some time in the Sixties and early Seventies, the excitement I went through, when for the first time, television came to our doors. It was a black and white television box. It had only one programme, which was a Sunday evening movie. All of us in our family, which was a joint family, would gather together and watch the Sunday evening Television movie because that was the only programme on this wonderful box called the black and white television. Today, we have more than one hundred channels, round the clock -

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* *The author is Executive Vice-Chairman and Managing Director of Kotak Mahindra Bank Limited. The text is based upon the Annual Public Lecture delivered under the auspices of the Trust on 11th February 2003, in Mumbai. The Lecture was sponsored by Bank of India.*

24 hours - and we still keep on flicking between channels with the brutality of an instrument called the remote.

There is a paradigm shift in our lives. More recently, let us look at ten years ago, there was no concept, at least in our lives in Mumbai, of the mobile phone.

Today it is so much a part of our lives that we are now working in the reality of having a television in our mobile telephone. So this is the nature and extent of the paradigm shifts, which we have seen in front of us, in our lives. However, when we look at these paradigm shifts, I would like to give the examples of the eighteenth and nineteenth centuries, when we saw a number of innovations. One such innovation was generation and distribution of electricity. In those days this change also was perceived as a paradigm shift and many, many electricity companies were set up, and as is wont with exuberance from the financial sector, every bank and investment bank in those days went after these electricity companies, and went overboard financing them. And I am talking about a hundred years ago. Yes it was paradigm shift in the real sector. The financial sector gets impacted by these shifts in the real sector. As is the case of the electricity companies, what happened was, electricity as a paradigm shift, is real and with us even today. But most of those electricity companies have died.

Therefore when we are talking about these paradigm shifts in the real sector, the financial sector is impacted by these paradigm shifts. But it has to have the ability to make that balance between real life change and the financial paradigm changes. A classic example in front of us, is two years ago or three years ago, when almost everybody in the real sector and the financial sector was just chasing one dream, the Internet -

a new paradigm shift that was going to change everything. People gave crazy valuations for Internet companies and all sorts of Internet companies came into being with names like flowers.com.There was no revenue model, but companies were valued by people financing these companies on the basis of the number of hits on the sites. This is two or three years ago. Yes, Internet has fundamentally changed our lives but we got excited with this change and the over-exuberance of the financial sector actually saw the damage wrecked on the global economy by this change. You will therefore observe, that while the financial world absorbs these changes and gets impacted by it, it is extremely important that the fundamental principles of financing do not change. Principles of prudence, principles of trust, principles of conservatism - they have to continue as the bedrock of financing, whatever paradigm shifts happen in our generation. With this I would like to turn to the ten key paradigm shifts we have seen at this point of time in the world of financing.

The first shift I would clearly define as a mindset shift. And if I take the liberty with the Trust , I would say the word, 'Financing', is obsolete. The appropriate word for today is 'Financial Services'. It is a mindset change. History has it that there was a point of time, that when somebody wanted to borrow money, he would go to a Bank or a financial institution asking for it. The concept has changed. The approach and attitude has to be that of servicing the customer who wants money. The need for the financial sector is to really have that services-oriented approach for lending money. This mindset change is a paradigm shift from the past. We are in the business of financial services, not financing.

The second very major change that we are experiencing is a shift from what is known as traditional lending to solutions. The customer of today is no longer interested in a simple commodity product when he borrows money or deposits money with a financial institution or a bank. He is looking for solutions to his problem. And therefore the entire area of financial services in the financial sector has moved from what I would call, a static kind of approach to the business, to a very dynamic-oriented business-approach of solutions. It is similar to when we go to a doctor, we want above all, the diagnosis of what is wrong with us, but more importantly, how we are going to fix it. The financial advisor or intermediary of today is expected to provide that advice and solution.

A few weeks ago I happened to be on a flight with a very senior ex-bureaucrat of the government, who had just retired. He said that he was getting a small amount of money as savings at the end of his career and that he had gone to his bank and the bank had told him to put it in a deposit. The deposit gave him an interest rate of six and a half percent and he had to pay tax on it. So he said after tax on his savings, he would get about four, to four and a half percent return. I just happened to tell him to look at RBI Relief Bonds. In the case of retired people there is no limit of Rupees two lakh and he would probably get a tax-free return of eight percent. The man was not aware of it. And we are talking about a very senior officer who you would assume, would know everything happening in business and finance. He then requested for someone from my office to contact him, saying he would like to do that right away. The next day, before I could reach back from Delhi, there was a message at my office saying that I was to send somebody, but nobody had come so far. We immediately sent somebody. The point that I am making is that the customer of today is looking for what he believes is dispassionate, honest advice. He wants a solution. There is a need for this solution at a time when we are seeing interest rates probably at their lowest in history.

The third major change is important in the context of the phrase that is used, which is, industrial financing. I think that we have moved from industries to services in a big way. That does not mean that industry is not a part of the financing umbrella. But services is becoming such a big part of our economy and therefore when we talk about financing, we need to be thinking about not just financing industry, but financing the Services sector, whether it is media, whether it is software or whether it is business process outsourcing. We need to find out ways and means and I think the finance sector is doing that to a certain extent, but we need to do a lot more, to be able to finance these new growing sectors which are going to be in a sense, the fundamental platform of the Indian society in the future.

A few weeks ago when I was in Davos, one of our very eminent management experts, Mr. C. K. Prahalad was speaking at a particular session. He predicts that in the next five to ten years, all the major multinationals in the world will be restructured as a single unit with three parts. The front-end part will be wherever the businesses are, which is the US, Europe or anywhere else. The second part, which is a manufacturing part of this entity, will all be done in China, and the third part, which is the process and outsourcing part, will all come to India. He therefore predicts that future companies in the world will have these three parts integrated into one end-piece. And therefore if we take this forward, we have the opportunity of seeing a huge growth in the services sector and I am in no way agreeing with him on the point that all the manufacturing is going to be in China. I think we can get a part of that as well. But services are going to be a very big part of our financing future and therefore in a sense, we need to find out creative ways to raise equity and debt finance for the Services sector. And let us be clear. As I mentioned earlier; we have not been used to intangible financing. Our mindset is, financing something which we can see, because that we can touch and feel. How do you finance intangibles and that is an important change which we are all going through.

The fourth major paradigm change I am seeing in front of us, is a movement from products to customers. Historically, the business of financial services by whichever institution in India, has been product-focused. And we all are going through that change. Let us go back to the history of one of India's most eminent institutions - HDFC. It started as a home loan company. It was product-focus, which was the starting point of that company. Each of us, in a sense, have focused on specific areas of products, whether it is home loans, whether it is mutual funds, whether it is insurance, or whether it is banking products. But the key focus is products. The future of the financing business is going to be customer-centric. We need to think 'customer'. We should be able to do cross-selling, which is a very different and difficult situation in the financial sector, where thinking 'customer', we should be able to sell a number of products in our channel to that customer base. Much easier said than done. It leads to serious conflicts even within the same organization, because most of the present organizations are focused on silos. People will be selling home loans, people will be selling mutual funds, people will be selling credit cards, but how do you think 'customer'? How do you measure profitability, not on the basis of products, but on the business from the customer? And this is a paradigm change. The ability of the financial sector to move from thinking 'product', to thinking 'customer', is going to be a key factor in the future success of financial services in India. In a sense, the financial services business is becoming more and more like an FMCG business than the traditional financing business which all of us have been used to. And our ability to understand the customer or consumer language is going to be key, for being able to execute services in line with his expectations.

The fifth, again, is a paradigm shift from wholesale to retail. Again the concept of Industrial financing, or concept of financing, as we have understood over the last few decades, is undergoing a change. I don't know how many of you receive very irritable phone calls on your mobiles from some direct marketing agent, trying to push some banks' unsecured personal loans. You will get a call when it is most inconvenient to you. "Sir we are ready to give you a loan for so-and-so amount at so-and-so rate within the next 24 hours. When will you take the money?" You say, "I don't want the money", and you put the phone down. But this is reality because we are now moving into an era where the concept of financing is moving to the smallest level. Of course I think there are challenges. And if you look at this extreme, in a sense right now, it can go overboard. Korea for example is seeing that. There is a consumer finance bubble, which is being created there. And if you go back to the home of all financial markets, the US markets, you did see a bit of excessive marketing to the consumer, where the consumer was excessively indebted. In India this is still a relatively new phenomenon. The consumer unlike a lot of industry, is under-leveraged. The amount of equity he has, compared to the leverage he has taken on the balance sheet, still make him a very sound risk from the point of debt equity ratios. Significantly better, than most industrial enterprises. And therefore the financial sector is going overboard to reach out to this consumer and lend money to him. Therefore this is a dramatic paradigm shift in the financing business, where more money is given to retail than to wholesale. In fact for the last two years, I don't see any major project financing happening in India, in the traditional industrial financing sense. If at all the financing in the so-called projected financing has happened in any sector in India, on the wholesale basis, it would be the telecom sector. Other than that, there has been no serious wholesale financing that has happened at a project level in India. And this is a very significant change in the entire financing paradigm. It is possible for consumers to get loans, it is possible for small and medium businesses to get loans, it is possible for people in restaurants, Doctors, Chartered Accountants, and everyone to get loans today! And in a sense they are all actively marketed. Yes, this is still much more an urban phenomenon, but over the few years this will spread widely to the length and breadth of the country.

The sixth paradigm shift as I see it, is from development to commerce. Most of the historic development lending, in the way it was done, where the major purpose of lending was development and not commercial, is a thing of the past. But it is taking a very new and interesting form. People are thinking commercial, but at the same time, they are seeing opportunity to actually lend to education, to research, to agriculture like never before. And in a sense, they are implying that developmental financing makes commercial sense. And we can actually find out innovative ways of doing what is right for society, as well as, what is right for the business.

I think the big challenge here, where I still feel a lot more can be done in the entire area of commercial financing for development, is agriculture. And my view is probably at some point in time if the central bank decides not to put priority sector targets, you will actually see creative development financing in agriculture, than when it is actually mandated to do it. This is because human nature is such that if something is mandated, it must not be good and therefore human nature is going soft at it. But the moment it is free market forces and you see opportunity out of it, the paradigm changes. My family comes from the agricultural and commodities business. Even today, if you go to the agricultural sector, particularly in the busy season, against a normal interest rate of 7, 8, 10%, agriculture is ready to pay 18, 20, up to 24%, and still make it sound financing. Obviously the sector is completely unorganised, but I see that as a new paradigm happening over the next few years, where the financial sector and players like HDFC, ICICI and some of us in our small way, will go out and reach out for commercial reasons to these development sectors. So in a sense, we are moving from development to commerce, but we are moving from commerce to development as well.

The seventh major change in the financing business is from securities to cash flow. You are saying that the value of a property, the value of an asset, is nothing but the stream of cash flows it provides in the future and therefore what you are financing is not the underlined security, you are financing the cash flow with the security cover.

My last three points on changes are more substantive from the point of view of institutional framework and new opportunities that have emerged. The first one is the blurring of lines between institutions. Today, institutions are beginning to do everything.

A global example of a J P Morgan Chase or a Citibank, which is everything to everybody, is something that is developing. In India you are seeing that as between HDFC and HDFC Bank, you get a full range of services. So also an SBI or an ICICI.

The lines of activities of financial institutions are getting less and less compartmentalized. If I use the famous A. D. Shroff memorial lecture "Compartmentalizing Between Industrial Finance, Banking and Insurance", probably Mr. A. D. Shroff in today's time would have redefined the way he defined the financial sector. But this is a paradigm change. An institution does everything today. HDFC tries to sell home loans, mutual funds, and insurance to the same customer base. But there is a danger in this. And I don't think the jury is finally decided about whether this is the right model. The danger is, conflicts of interest. The first conflict of interest that we have seen demonstrated in a big way is a conflict of interest between commercial banks and investment banks. This is a big issue as you are aware, particularly in the international markets, but will become issues here, and we need to have proper guidelines and safeguards for that. In investment banking the biggest conflict is between: Are you advising the issuer or are you protecting the rights of the investor? And it is found pretty widely that if you have a relationship with the issuer, there is a temptation that the equity side would be soft in terms of its recommendations on that company vis-à-vis the investor. So whose interests are you serving? The argument is that you cannot service both, because of a fundamental conflict. The issuer when he is issuing, wants a higher price, the investor wants it cheaper. Therefore where is your interest as a financial intermediary in the financial chain? Are you for the investor or are you for the issuer? And you have seen the conflicts, particularly in some of the international examples like Enron and WorldCom. These have become big issues. And therefore as we see this paradigm shift happen even in India, where some of us go into multiple activities, it is our challenge to make sure that we have proper processes, whereby conflicts of interests between different arms within the same firm are well handled and well defined. Therefore in a sense, this is a double-edged sword of the 21st century, started in the 20th century and we need to make sure that we do not repeat the same mistakes as some of our western counterparts.

The ninth paradigm change is really very recent. Derivatives, the new animal! Yes India had a history of many, many years ago, of futures, options, jotas and all that which we are familiar with in the traditional Indian market. But for the last many years it is out of fashion. It has come back. It's like saying what was fashionable wear in the 1940's, comes back in 2000. Similarly derivatives are back. And with that comes a whole range of challenges. In a sense what is happening is that the derivatives market will create trading platforms and instruments, which will be completely unconnected with the fundamental source of that instrument. If an HDFC or any other institution issues paper, that paper will be traded, not just as a bond, but there will be a swap around it, there will be hedge around it, there will be foreign currency transaction around it. And you will create multiple structures and instruments around the base instrument. This creates a huge amount of opportunities and ability for companies to raise money in different manners, and at the same time hedge against risks. But the understanding of this market for the average Indian public is something that will take time. This is reality. Derivatives, the new animal is here, and we have to live with this paradigm change in the financing module.

And finally, money is water. Money flows across the globe. It has no destination. It just moves wherever it gets the best returns. And as I talk to you, we really have to look at the power of these global flows, by just looking at the size of our foreign exchange reserves. And why is it happening? I think it is happening because you and me - the world at large - have realized that if I am getting one and a half percent interest in dollars, and if I invest in a rupee deposit, I can get six percent interest in rupees. I can hedge my rupee forward position, with a 3 to 3.25% forward cover. I am basically getting double the returns in dollars compared to what I am getting in my home market. And global flows will come. Importers will keep their suppliers credit imports open. Exporters will book forward. NRIs will bring money. And the global flows will come. As they say, when it rains it pours. And you can see it in our reserves every week. The counter is true. When they change they go out that fast. And we have seen the East Asian situation a few years ago. The surfeit of liquidity, the comfort of being able to build balance sheets, lend, consumer finance, and do it all, on the back of serious global flows. We need to have mechanisms as we open ourselves to changes, as to how we are going to handle the situation when water flows the other way. And this is a part of our challenge.

That brings me to another very important point, the whole area of risk management. It's taking a completely new dimension in today's times. I was glad to hear Mr. Deepak Parekh* make a statement that in the last 20 years I may have matured a bit. However, if there is one thing, which makes me paranoid, it's the whole area of risk. What keeps the CEO in any financial

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* *Mr. Deepak Parekh, Trustee, The A. D. Shroff Memorial Trust and Chairman, HDFC Ltd., presided over the Lecture.*

institution awake? It's risk. It is not just credit risk. It's interest rate risk, it's volatility, it's operating risks, counter party risks, and a completely new risk in the last few years, which I term as event risk. The 70's, 80's and 90's have been benign years from the point of event risk. 9/11 (September 11, 2001) has changed that. And you are now actually living in a world of risk where you do not know how this event risk can be evaluated in your business model.

And it is in a sense, a zero one situation. You can't completely plan for it. Is there going to be a war between the US and Iraq? Is there going to be a war in Palestine? Are things going to be normal between India and Pakistan? We saw the tremors in May last year, when the fear of an India-Pakistan war was at its height. And it was a zero-one situation. How do we as players in the financial sector plan for this completely uncontrolled risk?

The financial sector is getting interplayed and interwoven with the commodity sector - oil, gold.....! So the whole concept of financing is taking a completely different dimension in this new era. You have to measure risk; you have to measure the prices of commodities. If oil goes up, if gold goes up, it is something, in terms of what is going to happen to currencies and interest rates, and that paradigm shift, friends, is pretty awesome.

With that I would just like to put a few specific issues of concern and challenges for us in the future. Maybe, a few micro issues on the financing side. And it is something that we need to be aware of, as we build the Indian financial markets.

The first big challenge in the financing model in India is that as the bond markets have developed, the AAA (triple A) gets all the money. The moment you move down to a lower-rated paper, you not only find it difficult to raise money for lower-rated bonds, but the spread between the AAA and the lower-rated bonds is disproportionate. It is reflective of a market, which is still young, immature and does not have depth.

It brings us to a second point. This is something which I think, should be of great concern for us. Almost the entire money in the bond markets with the exception of LIC, is short-term. All mutual funds are like bank current accounts. The money from mutual funds can move overnight. There is no long-term money that is actually flowing into these bond markets. And you find the bond markets trading 10, 15, 20 year paper. If there is a correction and a reverse flow of water, how will the Indian markets with all their thinness, withstand the shock in the system.

The third point is equity financing. The Indian retail investor does not want to take risk. There is no other reason why 70% plus of HDFC should be owned by Foreigners and FIIs. Yes we treat all of them equally. But the Indian retail equity investor does not want to take risk. I mean he has been burnt, maybe for good reasons. But other than LIC again, no other institutional mechanism is in place, and it will be some time before insurance companies come into play with long term money as surpluses. Same issue with private equity money. Most of the long-term private equity money is coming from international sources. Very little from domestic sources. Another big gap is coming in the entire area of project finance with IDBI, IFCI defocussing on that, and ICICI moving much more to what I defined as the more glamorous retail sector. IDFC of course is relatively a new entrant but an active entrant. If the growth in the Indian economy takes off, how will new projects get financed without the presence of serious term institutions? We do hope that in addition to IDFC, the State Bank, Bank of India, and others will step in, to support project finance as a serious activity for growth.

And the last point is the anomalies in the interest rate structure in India. As I mentioned, the advice that I gave earlier to my customer friend, on putting money in 8% tax-free bonds has a reverse implication. We have a dysfunctional interest rate structure. A ten-year government securities, is six and a half percent today. Taxable. Therefore, if you as an investor, buy a Government of India paper - ten-years maturity, you will get six and a half percent, on which you will pay tax. The same Government of India has issued another security right now, which is seven percent tax free - six years. It is these anomalies that we need to come to terms with, including with our provident funds, where the rates are high. I think we need to get an alignment of the interest rate structure, otherwise we will have an issue with the overall financing of the Indian industry and service sector in the future.

So, if I have to sum up, I am reminded of a very famous Shakespearian phrase which if I am permitted, I would use. It says, "Markets of today are like fickle women, ever changing, never constant". Banks and financial institutions in today's time, face the challenge of handling these fickle markets. And the paradigm of the financial world shifts along with some of the paradigms of the real world. Amidst all these changes, the financial institutions and the financial sector have only one thing constant. And that constant is their core values to create trust, protect highest standards of corporate governance and transparency. I remember Mr. Deepak Parekh once telling me, and I think this is a mantra he uses inside his organization, that the standard in your organization should be such, that if something became public, you would not be embarrassed by it.

And therefore friends as we grapple through very fast-changing situations, both in the real world and in the financial world, we as practitioners in the financial sector need to be constantly reminded and focus on the fact, that we are in a business where we have to build trust, governance and transparency. That is always a constant!

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* *The A.D. Shroff Memborial Trust has no specific views on these economic issues. This publication is issued for public education, and hence the views expressed are specifically those of the author.*