The Economist

Special report:
Banking in emerging markets

Mutually assured existence

Public and private banks have reached a modus vivendi

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“INDIA is where China was ten years back,” says Mr Kamath, chairman of ICICI. That is certainly true by size. India's GDP amounts to about a quarter of China's today and its banking industry just a tenth. But in at least one respect India is well ahead: it has several dynamic privately owned banks that over the past decade have taken a fifth or so of the market from the state-controlled banks. Until the financial crisis in the West the private banks seemed to offer a template for the entire industry: within a decade or two, it seemed, the state would retreat significantly. Now India's mixed model of banking is likely to persist for longer.

Part of that reflects the fact that India had its own wobble during 2008. This was not a full-blown crisis; indeed, Aditya Puri, chief executive of HDFC Bank, the second-biggest (and perkiest) private firm, says to describe it that way would be an “appalling misconception”. But there was a sharp spike in money-market interest rates after the collapse of Lehman Brothers, a liquidity squeeze and a notable shift in deposits. At ICICI overall deposits, as well as the stickier category of savings and current-account deposits, dropped by about a tenth between June and December 2008. Savers shifted their cash to the government-controlled banks, which were perceived to be safer. “Money was pouring out of our ears,” says Mr Bhatt of State Bank of India.

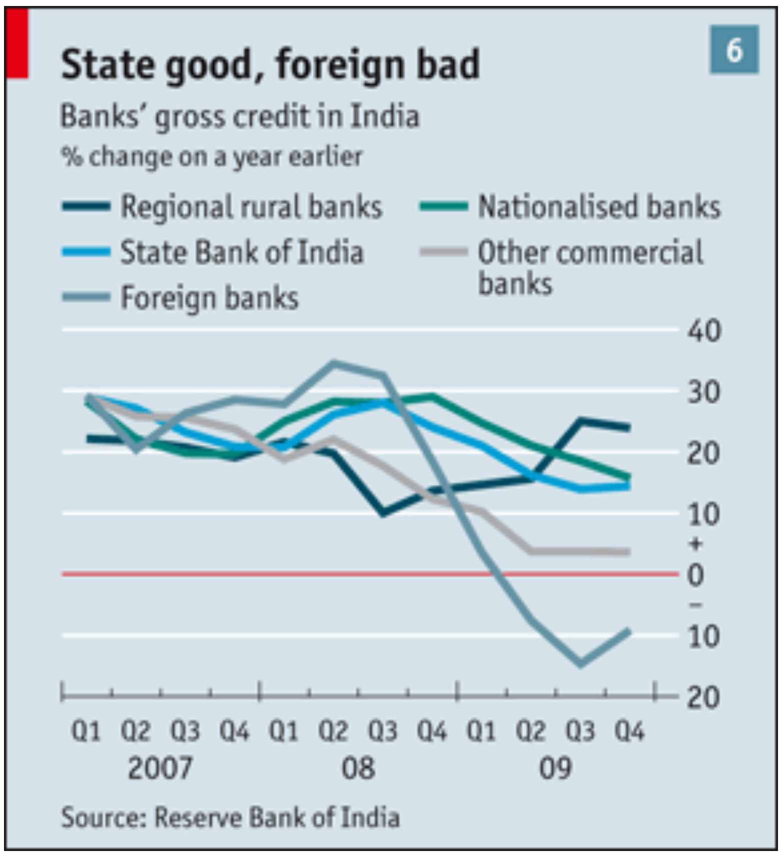
That experience has helped prompt a change of strategy at ICICI, which for a long time was one of the most admired private banks in the developing world. After a decade of spectacular growth, fuelled in part by wholesale funding (including bulk deposits), the bank recently slammed on the brakes. In 2009 its loan book shrank by 17%.

Chanda Kochhar (one of several female bank bosses in India), who took over as chief executive from Mr Kamath last year, says that the bank decided to focus on changing its funding mix towards retail deposits because as interest rates rise these should be cheaper as well as stickier than wholesale funds. Current and savings deposits now make up 42% of total deposits, up from 27% before the crisis. Private banks so far lack the state banks' huge branch networks, but they are working on it. ICICI now has 2,000 branches, against only 755 in early 2007. That should help it suck in more deposits.

The state banks may hold on for a while yet to the market share they have taken. Between June 2007 and December 2009, after a long period of genteel decline, they saw their share of total deposits and loans rise from 73% to 77%. After years of fierce competition from the private banks, they have begun to get their act together. At State Bank of India's headquarters in Mumbai visitors may still receive a smart salute from a man in uniform, but, Mr Bhatt says, its technology and products are now “comparable to the private sector”. Mr Kamath agrees that the state banks have caught up on technology.

Learning to love state banks

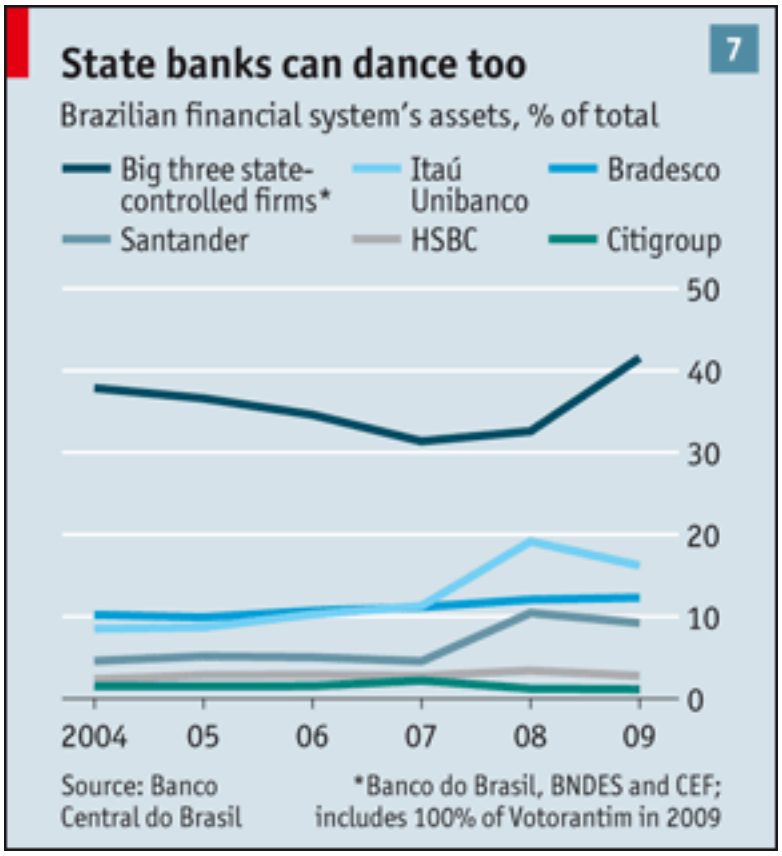
Yet even if the private banks do go back on the attack, attitudes towards the state-controlled banks have changed for good. After all, they were the ones that continued to supply credit to the economy during the downturn. Before the crisis all banks were expanding their loan books at an annual rate of about 25% (see chart 6). After mid-2008 there was a big divergence, with the state banks (which come in three main flavours: the nationalised banks, State Bank of India and the regional rural banks) keeping credit growing fairly steadily. The private banks more or less ground to a halt. The foreign banks went from expansion to sharp decline, with their share of loans dropping from a peak of 7% to a paltry 5.3% last December.



Most bank executives now also concede that old-fashioned regulation was shown to have its merits. Indian banks are required to hold a big slug of their assets (typically just under a third) in government bonds and at the central bank. Now Western regulators too are considering pushing up liquidity levels. Indian bankers joke that all the fiddly rules they face have become the envy of regulators throughout the world.

All this has led to a reappraisal of whether state banks should be fully privatised in the long term. HDFC Bank's Mr Puri says that “the world has changed and the view around here has changed.” Mr Kamath takes a similar view, predicting that in the new circumstances “India's evolution will be more or less in line with China's.” Mr Bhatt reckons there will be “no big-bang reform” and that over time the state-controlled banks' share will drop only gently, to 55-65% of the market.

A similar message is heard in Brazil. In the past five years Brazilian private banks have risen to global significance, helped by a frenetic 2007 and 2008 when an eighth of the system's assets changed hands. Itaú bought Unibanco and Santander bought ABN AMRO's Brazilian business.



But just as important has been the expansion of the state banks, Banco do Brasil (a listed commercial lender with a bias towards agriculture), Caixa Econômica Federal (a mortgage specialist) and BNDES (which acts more as an investment company). Together their share of the financial system's assets has reversed its earlier decline and now stands at 42% (see chart 7). Part of their increase in market share reflects acquisitions, with Banco do Brasil buying Nossa Caixa, a mid-sized state-owned firm, in 2008 and a 50% stake in Votorantim, a car-finance specialist, in 2009. But about two-thirds of the rise has come from lending more than the private firms during the downturn.

That in turn has changed people's views of a mixed financial system. Domingos Abreu, chief financial officer of Bradesco, says the state banks “had a very important role…in the government's anticyclical policies”, adding that in a downturn “it makes a difference” to have a mixture of state, private and foreign banks. He concedes that two years ago he might have answered the question differently, but now he had to acknowledge that the state banks have their merits.

Alfredo Sáenz, chief executive of Santander, which owns the country's third-biggest private lender, quips that Brazil keeps an “artistic equilibrium” between the private and the public sectors. Persio Arida, a former governor of the central bank and president of BNDES, and now a partner at BTG Pactual, Brazil's leading independent investment bank, says that the “consensus” in the country is that the state banks played a vital role. However, he cautions that until the extent of bad debts created by their lending is known, no definitive judgment can be reached.

Russia holds the line

In Russia up to 54% of the system's assets are state-controlled, according to Andrei Vernikov, an economist, compared with 45% in 2007. Foreign banks' share stands at 18%. The balance-sheets of the three European banks that are most active in Russia, UniCredit, Raiffeisen International and Société Générale, together shrank by about a quarter in euro terms in 2009. Royal Bank of Scotland's loans to Russian corporate customers dropped by 45% in sterling terms. Net loans at state-controlled Sberbank and VTB declined by only 4% and 10% respectively in local-currency terms. Last summer the government took a larger stake in VTB to bring its holding up to 86%. Andrew Keeley, an analyst at Troika Dialog, an investment bank, says that although the government is likely to sell the additional stake in VTB again, it intends to keep majority control of both big banks.

But none of this means that a Soviet-style banking system is about to emerge in any of these countries. In China the government did take control of credit during the crisis, but for other state banks it was more of a nudge and a wink. Mr Bhatt says he was left to his own devices. Most governments also want private-sector banks to raise the level of competition. Even in China the state accepts some innovative upstarts, such as China Merchants Bank, a mid-sized bank with diffuse ownership and no direct state control. And all emerging markets want some foreign banks in order to keep local firms on their toes.

So although the ratio of ingredients varies, the objective mostly seems to be a mix with a strong state presence. This is seen as more responsive to businesses, less vulnerable to flaky foreigners and more open to "soft" control by the state as it tries to manage the economic cycle. Western bankers see its merits too: HSBC's Mr Geoghegan, a veteran of banking in Latin America, the Middle East and Asia, reckons that a healthy combination of foreign and local firms leaves foreign banks politically less exposed.

Control freaks

The problem for state banks is that they need to find a way of raising capital without diluting the government's holding. Most state-controlled banks are listed because a quotation brings market discipline to managers and provides useful information about the performance of the bank. But governments seem determined to hold on to a stake of at least 51%. For example, Banco do Brasil, now the country's largest lender by assets, announced plans to raise $5 billion earlier this year, but its objective remains the "maintenance of the government's shareholding control". Turkey is thinking about floating its largest lender, Ziraat Bank, but the state seems likely to retain control. It is the same story in China, says Bill Stacey, an analyst at Aviate Global, a brokerage firm. The government is happy to sell shares in banks but wants to keep a majority stake. Likewise, in Russia the state wants to retain control of the two biggest banks.

What happens when the state's holding gets close to that crucial 50%? State Bank of India expects to receive a capital injection from the government this year. Its chairman, Mr Bhatt, says it is still an open question whether the state might breach the 50% threshold in the medium term, but even then it would seek to have a big enough stake to remain the dominant shareholder. Many governments are in better fiscal condition than India's and have more scope to top up banks' capital.

Emerging-market banks' hunger for capital used to ensure that they would ultimately be sold off to the market—or to foreigners. Not any more. So the prospect now is of a fast-growing, innovative banking industry that remains subject to conservative regulation and only gradual shifts in control. After the West's experience with no-holds-barred banking, that may be a good idea. But for growth-starved Western banks desperate to do business in emerging markets it means they will find it even harder to get in.

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