

## **Future growth drivers : Retail versus corporate**<sup>1</sup>

Good afternoon, ladies and gentlemen. It is my pleasure to be here in the precincts of one of the premier business schools of India. When Mr. Bhusnur Math, an ex-RBI colleague, approached me for this seminar, I must concede it was the association of MDI with the event that made me accept the invitation. The way the world is changing and becoming more complex, newer challenges are being thrown up necessitating more interaction and dialogue between academia and the policy making institutions. We, as the central bank and regulator of the financial system, surely realize the significance of such association. Our entire regulatory approach has evolved into an inclusive consultative process, with formal association of many academicians as members of various working groups and committees. This approach has benefited us immensely and we intend to improve upon the consultation process in future.

In today's session, I have the onerous task of carrying through the most difficult session in any seminar - the post lunch session. Banking is undergoing interesting times in India and I hope some of vibrancy evident on the ground gets permeated to the deliberations in this session.

Over the last decade and a half, the banking sector has undergone a phase of intense churning, triggered by the initiation of the reform process in early nineties. Today, we find ourselves at a stage where the banking environment is underpinned by:

- sufficient operational flexibility for banks, which ensures decision making on a commercial basis,
- increased competition for banks on both assets as well as liabilities side,
- emergence of other non-bank financial intermediaries,
- technology-aided proliferation of different service platforms

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<sup>1</sup> Address by Smt. Shyamala Gopinath, Deputy Governor at a seminar at MDI, Gurgaon on December 3, 2005.

- integration of a risk management culture within the strategic framework with availability of various risk management instruments

The theme for this session is clearly a reflection of the changed times, when retail/corporate businesses are being talked about as viable business propositions and future 'growth drivers'.

Retail banking is becoming an increasingly complex concept to define. While "pure" retail banking is generally conceived to be the provision of mass market banking services to private individuals, it has been expanded over the years to include in many cases services provided to small- and medium sized businesses. Some banks may also include their "private banking" business (i.e. services to high net worth individuals) in their definition of retail banking. The advantages of a retail franchise are numerous:

- Retail banking clients are generally loyal and tend not to change from one bank to another very often;
- Interest spreads are wide, since customers are too fragmented to bargain effectively; Credit risk tends to be well diversified, as loan amounts are relatively small;
- There is less volatility in demand and credit cycle than from large corporates;
- Large numbers of clients can facilitate marketing, mass selling and the ability to categorise/select clients using scoring systems/ data mining.

Nevertheless, there can be some drawbacks in retail banking which have to be considered:

- There can be problems in managing large numbers of clients, especially if IT systems are not sufficiently robust;
- Rapid evolution of products can lead to IT complications;
- The costs of maintaining branch networks and handling large numbers of low-value transactions tend to be relatively high. (For

this reason banks are encouraging clients to use cheaper distribution channels, such as ATMs, the telephone or internet, for these transactions and reserve the branches for higher added value transactions).

In India, retail banking has always been prevalent in various forms ever since the evolution of banking. Co-operative banks that have been existence in India for over a century have always had retail thrust. It is only since the mid nineties that the term retail banking has been used as a means of reinforcing a conscious foray into this particular line of business. Retail banking today for many banks is synonymous with mainstream banking, with vast sums of money being invested in creating and sustaining a retail brand, further supported by requisite technological and staffing support. It is pertinent to ponder about the causes of the shift (or increase) of focus towards the retail side. There are several compelling reasons that have influenced this shift. They are:

- Fear of corporate defaults and NPA computation
- Relative safety implied by the mortgage loans
- Low credit off take during from the commercial and corporate sector during the period 2000-2003 (this trend has reversed, though, over the last year and a half)
- Lowering of cost of consumer durables and automobiles due to competition
- Increasing use of credit/debit cards as plastic money
- Automation of stock exchange operations, dematerialization
- ATMs, direct debit and phone banking as convenience factors
- Advisory services: real estate, investments and insurance

### **Recent trends**

It would be pertinent to have an overview of the recent trends in the two portfolios of the banks. Advances made by the commercial banking system as a whole

increased significantly by 33% in 2004-05. Contrary to the trend observed in the last few years, the growth in advances far outstripped the growth in investments which was to the tune of 8%. While rising interest rates which was particularly evident in the G-sec yields, led the banks to unwind their investment positions, the increased pace of the growth in the industrial and services sector aided the credit buoyancy in no small measure. The most significant component of growth, however, was the banks retail portfolio.

### **Corporate portfolio**

- Scheduled commercial banks' non-food credit, on a year-on-year basis, registered a growth of 31.5 per cent as on September 30, 2005 on top of a base as high as 24.9 per cent a year ago. Demand for bank credit has been broad-based led by agriculture, industry and housing sectors
- Latest available data indicate that credit pick-up during April-August 2005 was quite broad-based. The high growth of credit to the priority sector reflected largely the sharp growth in agricultural credit as well as small housing loans (up to Rs.15 lakh).
- In addition to bank credit, industry has also increasingly relied upon non-bank sources of funds in recent years. Equity issuances continued to be steady during April-September 2005, benefiting from buoyancy in capital markets. Mobilisation through issuances of commercial papers also remained strong. Funds raised through external commercial borrowings (ECBs), which were large during 2004-05, moderated. This was mainly on account of turnaround in short-term trade credits as oil companies increased their recourse to domestic financing

It is useful for the bankers to track the changing dynamics of the pattern of corporate financing. The equity base of the corporate sector, relative to debt, seems to have increased, and many corporates are currently cash surplus, presumably to meet their investment commitments. Besides, the corporates also

have access to other funding sources, especially external commercial borrowings and domestic and global capital markets. The Development Finance Institutions have substantially got subsumed in the banking sector and banks are increasingly functioning as universal banks. Banks' lending to households, be it through consumer credit or housing loans, has been increasing in the recent past along with increases in lending to priority sectors. It may, therefore, be worthwhile for banks, especially those with long history, to review their systems and procedures for lending and extending other forms of support to the corporates. An area of concern, in terms of public perception, is that there is under-pricing of credit risk for private sector corporates while there could be overpricing of risks in lending to agriculture as well as small and medium enterprises. There is merit in reviewing the current procedures and processes of pricing of credit, perhaps through a well structured segment-wise analysis of costs at various stages of intermediation in the whole credit cycle.

### **Retail portfolio**

Retail segment, which witnessed a frenetic growth over 2003-04 seemed to maintain their momentum in 2004-05. Retail advances in absolute terms have increased by Rs. 77,588 crore in 2004-05, and their share in the scheduled commercial banks' total loans and advances increased from 22.0% as at 31<sup>st</sup> March 2004 to about 23.7% on 31<sup>st</sup> March 2005. Retail loans registered a growth of 41% as against a growth of 33% in the overall loans and advances of the banking system. Housing finance, logged a 50% growth in 2004-05. The other driver of retail loans was 'Other Consumer Finance' which comprises auto loans, loans to professionals and educational loans etc which recorded an impressive growth of 32.6% during last fiscal. The same trend continued in the first half of 2005-06 where the retail loans grew at an annualised rate of 39% as compared to a 22% annualised growth of the investments portfolio. The point to be noted is that while growth in corporate advances due to the growth momentum in the industrial sector is very impressive, retail story continues to hold good.

The overall impairment of the retail loan portfolio worked out to 2.8 % in March 2005 and compared quite favourably with Gross NPL ratio for the entire loan portfolio, which was 5.1%. Within the retail segment, the housing loans, which formed around 50% of total retail portfolio, had the least asset impairment at 1.9% while credit card receivables had very high impairment at 7.9% in March 2005. However, the disconcerting feature in the asset quality of retail portfolio is that while overall NPA level in the industry has been consistently coming down, NPAs on the retail side point to a contrary trend. Though the increase in the NPAs in the retail segment may not be very substantial as to warrant immediate concern, NPA levels in the retail segment are steadily inching up nevertheless. This points to the need to exercise caution by the banks in all aspects of retail loans administration.

In recognition of the inherent risks in high growth of retail credit, particularly the housing and personal loan segment, the Reserve Bank cautioned banks about the need to sharpen their risk assessment techniques so as to guard against any adverse impact on credit quality. As a counter cyclical measure, risk containment measures were prescribed on housing and consumer loans, and the risk weights in the case of housing loans and consumer credit, including personal loans and credit cards were increased from 50 per cent to 75 per cent and from 100 per cent to 125 per cent, respectively, in the Mid-term Review of Annual Policy for the year 2004-05. Furthermore, keeping in view the sharp increase in credit to real estate, banks were advised in July 2005 to put in place a Board approved policy with regard to exposure to the real estate sector and to submit disclosures to the Reserve Bank in separate returns.

**High mortgage credit growth a concern?** The penetration level in housing in India is still one of the lowest in the world. The mortgage to GDP ratio is around a measly 3%; this compares to 51% in the U.S and 12 to 20% in more economically comparable countries.

However, experiences in other countries show that any increase in real estate prices is generally preceded or accompanied by a boom in banking credit and/or expansionary monetary policy or easy liquidity conditions. A subsequent tightening and/or a collapse in the market prices may lead to increased credit risk. The relationship between the real estate prices and housing loans is required to be monitored closely. The long-term nature of the mortgage loans, coupled with very low interest rates, may also affect banks heavily if the interest rate goes up significantly. Further, increased competition may lead to adverse selection, which, in the event of a fall in the real estate prices may expose the banks to higher levels of risk. A significant amount of the personal loans could be non-collateralised and a source of potential vulnerability in the event of default.

Internationally, a view has been emerging that Loan-to-Value Ratio (LTV) being a dominant indicator of default probability of housing loans, loans with high LTV (say above 80%) could be assigned higher risk weight. The suggestion is based on empirical evidence from some countries. However, the likelihood of default and the gross severity of loss in the event of default are positively correlated with the LTV, only when all other factors are held equal. Therefore, a more risk sensitive capital allocation framework would suggest that LTV should be considered as the risk indicator of an individual loan in conjunction with overall credit quality which is a function of many aspects such as quality of credit appraisal, installment to income ratio, trends in prices of real estate, efficacy of foreclosure laws, purpose of purchasing/constructing a house i.e. whether as an investment or for living.

The guidelines laid down by RBI for adoption of Basel II norms for Capital Measurement and Capital Standards, prescribe differential treatment for various counterparties, including retail. All such claims that meet the specified criteria could be included in a regulatory retail portfolio and assigned a risk-weighted of

75%. Among other things, the criteria are intended to ensure sufficient diversification and containment of concentration of aggregate individual exposures.

### **Issues in Retail banking**

On this issue of retail banking, there is also a need to stress the associated responsibilities to be recognized and addressed by the banks, particularly in the area of transparency in the services provided. Internationally, there is a growing concern regarding the retail customers being subject to a slew of hidden costs, which constitute a staggering component of banks' revenues.

In recognition of this concern, RBI has recently come out with guidelines for credit card operations of banks, addressing the issues of transparency in interest rates, wrongful billing, protection of customer rights and privacy, fair Practices in debt collection to ensure a semblance of transparency in their operations.

RBI is also in the process of setting up of an independent Banking Codes and Standards Board of India to ensure that comprehensive code of conduct for fair treatment of customers is evolved and adhered to. There would need to be a formal covenant between a bank and the Board, which would *inter alia* include the disciplinary powers of the Board and this document would serve as a Registration.

Also, sharing of information about the credit history of households is extremely important as far retail banking is concerned. Perhaps due the confidential nature of banker-customer, banks have a traditional resistance to share credit information on the client, not only with one another, but also across sectors. Globally, Credit Information Bureaus have, therefore, been set up to function as a repository of credit information - both current and historical data on existing and potential borrowers. The database maintained by these institutions can be accessed by the lending institutions. Credit Bureaus have been established not only in countries with developed financial systems but also in countries with



relatively less developed financial markets, such as, Sri Lanka, Mexico, Bangladesh and the Philippines. In Indian case, the Credit Information Bureau (India) Limited (CIBIL), incorporated in 2000, aims at fulfilling the need of credit granting institutions for comprehensive credit information by collecting, collating and disseminating credit information pertaining to both commercial and consumer borrowers. At the same time banks must exercise due diligence before declaring a borrower as defaulter.

Finally, outsourcing has become an important issue in the recent past. With the increasing market orientation of the financial system and to cope with the competition as also to benefit from the technological innovations such as, e-banking, the banks are making increasing use of 'outsourcing' as a means of both reducing costs and achieving better efficiency. While outsourcing does have various cost advantages, it has the potential to transfer risk, management and compliance to third parties who may not be regulated. A recent BIS Report on 'Outsourcing in Financial Services' developed some high-level principles. A basic requirement in this context is that a regulated entity seeking to outsource activities should have in place a comprehensive policy on outsourcing including a comprehensive outsourcing risk management programme to address the outsourced activities and the relationship with the service provider. Application of these principles in the Indian context is under consideration.

**Ultimately, it's a question of which business model is adopted by the bank. The opportunities, on either side, may be leveraged by those who align their processes and systems to the requirements of the business. The complexities and risks being induced by technology, competition, innovative products, further deepening of other sectors of the financial system would have to be clearly understood and translated into the strategic focus.**

## **II. Going beyond**

Allow me the liberty to go a bit beyond the intended thrust of the theme. Retail and corporate businesses have surely emerged as distinct, viable business propositions, and it is healthy for the economy. However, the euphoria must not cloud the underlying philosophy of banking to 'intermediate between 'those having funds and those in need of funds'. There is still a very large section of the society that is out of the net of banking services, and hence denied of the benefits accruing of the same.

The annual policy Statement of April 2005, while recognising the concerns in regard to the banking practices that tend to exclude rather than attract vast sections of population, urged banks to review their existing practices to align them with the objective of financial inclusion. In many banks, the requirement of minimum balance and charges levied, although accompanied by a number of free facilities, deter a sizeable section of population from opening/maintaining bank accounts. With a view to achieving greater financial inclusion, all banks need to make available a basic banking 'no frills' account either with 'nil' or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population.

As a long term objective, our collective priority should be to expand banking services beyond credit into all the financial products on offer in more sophisticated markets. Today only a few institutions are seriously offering insurance, even though it is particularly valuable to the poor; yet death and illness, for example, are major risks for banks making small loans, and inevitably they charge for bearing that risk.

Before concluding, I would like to share with you the findings of a recent IMF study. The study analyses as to what is happening to the risks being transferred by banks through various instruments and concludes that it is households which

are carrying more of the risks contained in the financial system. As households take on more of these risks, they are also being saddled with more complex financial instruments. It would be good to think that the process of risk transfer filters out the most toxic elements and offers households a steady accumulation of value, but the chances are that the opposite is happening. Banks have tended to pool the cheapest (that is, the most heavily discounted) risks into baskets of assets which they then securitise. Households are not likely to have the time, inclination or ability to evaluate such offerings from banks, and financial advisers and fund managers do not have a good track record of explaining complex financial products.

We all need to contemplate over the above since, as an individual, the above is a bit disturbing.