Y V Reddy: Regulators' eyes on financial institutions

Comments by Dr Y V Reddy, Governor of the Reserve Bank of India, published in January 2007 issue of The Banker, London. It can also be accessed at www.thebanker.com.

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As we move from a world based on relationships to one based on transactions, can our banks be far behind? Indeed, banking has been transformed, perhaps unrecognisably, and regulators and customers are taking notice.

In the 1970s, a visit to the bank meant face-to-face time, assistance with problems, financial advice, and often just a friendly chat with your banker who you knew and trusted. Today, many customers and banks prefer point-and-click transactions, and face time can sometimes mean fees. And whether you are in Chennai or Chicago, the person answering your bank query is probably in Bangalore.

What does this mean for the banks, their customers and regulators? Banks rely less on customer loyalty and more on efficiency. Reputational concerns that were once paramount are less critical – witness the million-dollar penalties routinely imposed on some of the global banking giants; yet, they continue to grow.

Efficiency rules

Fee-based income has overtaken net interest margin income. Customers enjoy efficient transactions, but find themselves unequipped to make the best possible financial decisions with regard to their banking needs. It is perhaps significant that bank regulators, who were until recently content with bank licensing and applying prudential regulations while encouraging competition, are now focusing on preparing customers to deal with the banks.

Today, some banks levy a penalty or an interest charge for not maintaining a minimum balance, for not operating a bank account for a certain period, and for other negligent behaviour – although the interest charges paid by the bank for similar negligent behaviour are less than those paid by the depositor. These treatments are often sanctified by the terms and conditions imposed when an account holder opens an account. But in signing the contract, customers are not as empowered or as cautious as they should be. This could be due to several reasons, among them the prevalence of non-standard contracts that make comparison of competing products difficult and tend to dampen competition.

Educating consumers

In response to overcharging on credit cards and other issues, bank regulators are taking initiatives to prepare customers for the market by educating them (through financial education initiatives), counselling them (through credit counselling), and assuring them (of "fair trade practices" and "reasonable charges"). Regulators seem to be aware of the need to consciously connect the common person with bank services and equip him to manage the new reality of transaction-based but multi-faceted banking.

Regulators all over the world have recognised some market failures in savings and credit markets and that banks' sophisticated customer-segmentation strategy has unintended consequences. Thus, globally, financial inclusion is now a priority. Initiatives range from the Financial Inclusion Task Force in the UK, which has noted that better customer-segmentation technology has led to certain sections of the population being financially excluded, to the Community Reinvestment Act in the US, which imposes an affirmative and continuing obligation on banks to serve the credit and banking needs of all the communities in which they are chartered, to the initiatives of the Indian government and the Reserve Bank.

Regulatory sea change

Banks are special. They have special privileges and unique obligations. They are licensed to take uncollateralised deposits from the public but have a high degree of leverage. Their services are necessary. However, recent developments indicate a rebalancing of the focus of regulators and the awareness of bank customers. The regulators' thrust, of late, on financial inclusion, financial education, credit counselling, fair trade practices, reasonable charges and avoidance of unequal contracts is the right way forward to ensure an efficient, inclusive and equitable banking system.