R Gandhi: New paradigm in banking: banking is necessary, not banks – really?

Valedictory speech by Mr R Gandhi, Deputy Governor of the Reserve Bank of India, at the FIBAC 2016 "New horizons in Indian banking", Mumbai, 17 August 2016.

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1. "Banking is necessary, but banks are not", I am quoting here Bill Gates, what he said as Chairman, Microsoft, way back in 1994. Today, after twenty two years, has his prediction or forewarning come true? I intend to explore this in today's discussion with you.

2. It is usual for many of us who lecture others to say "We are at cross roads", "The Paradigm shifts that are staring us" etc. That's because it takes time to discern the trends that are taking place in any sector and unless we pause to look carefully, the emerging patterns are easy to be missed, at great cost to many stakeholders. And when we do pause and observe, we can't but say "We are at cross roads", "The Paradigm Shifts that are staring us" etc.

3. In the PWC Report in July 2014 on "The future shape of banking – Time for reformation of banking and banks?" they said that at the macro level, they had identified five global 'megatrends' whose impacts, intersections and collisions are re-shaping the business world. While these all are relevant to banking, they pointed out the most influential of the trends to be "the demographic and social change, creating new customer demands and stakeholder expectations; and technological breakthroughs changing everything from customer relationships to business models".

4. A Willis' research report published in Resilience in April 2015 said that the financial institutions industry – including banks, asset managers and financial technology companies – is currently faced with a paradigm shift caused by a number of key mega trends. It identified the regulatory capital requirements, digitalisation and technological advances, new market participants, demographic and behavioural changes in the new generation of customers as some of these trends.

5. A Report on "Connecting the Dots of the New Paradigm Shift in Banking: Where Are We Now?" by Scope Ratings said in June 2016 "Looking at the current trends, we view the crossroads for banks being laid rather precariously at the intersection of three powerful winds of change: Technology, Regulations and Macro developments (mainly sluggish growth and low-for-long rates)".

6. So what's common among all these researches? It is the emerging trends in technology, regulatory changes and consumer behaviour and expectations which are redefining banking and banks' role and even endangering banks' existence. Why do I say redefining banks' existence? That's because, as PWC did put it, if the banks were to not take full account of these trends and developments, they would risk emerging from the financial crisis "recapitalised, restructured, reformed …. but irrelevant". That's a profound statement in my opinion.

Technology, consumers and regulation

7. Banks today are forced to make rapid and irreversible changes due to the developments in technology, customer behaviour and regulation. Let us explore a bit more on these developments.

Technology

8. Channels – FinTechs – Apps-social media, are the buzz words.

9. Technological developments are changing the way the banks and their customers interact. These developments have created opportunities for new entrants, not necessarily new bankers, to disrupt traditional business models and penetrate new markets. The plethora of technological products and services, such as the World Wide Web, mobile phones and Apps, have helped emergence of FinTech companies who offer lower cost services for traditional services, such as e-payments and online trading. Social media companies such as Facebook, Twitter and Google have a huge customer following and are entering into the financial sector, bringing new sources of competition.

Consumers

10. Millennials- instant gratification – No loyalty, these are the buzz words.

11. There is a new generation of young people (known as millennials). They have different expectations and their ways of interacting with banks are also different. They prefer not to come to banks for banking services. Rather they would prefer to avail the services through online and social media based platforms. They are using social media not just to connect and communicate among themselves, but also connect and communicate with banks. Even to complain, they prefer online and social media and they do not have traditional customer loyalties. If Millenials behave this way, the Mature customers and Older / Retirees are demanding improved returns from investments and demand greater transparency.

Regulation

12. Standards – Consumer protection – Ring fencing – Capital, are the buzz words.

13. Since the financial crisis, regulatory emphasis have focussed more on capital. This has led many banks to divest themselves of ‘risky’ or capital intensive assets, businesses and even markets; this has also brought a sea change in bankers’ attitude towards risk and clearly marked the boundary between retail and wholesale banking. Banks have also been investing and recruiting heavily in compliance to meet new regulatory requirements.

14. Another offshoot of the stricter enforcement of regulations, is the increasing business and growth of non-banking financial institutions, the shadow banks that are not subjected to the same degree of intense regulation; they are offering competing services to bank clients, establishing specific funds or offering private equity.

15. Thus you will all readily agree that these three trends have clearly redefined banking and banks.

Banking and banks – redefinition

16. I also said these emerging trends are endangering banks’ existence. Am I echoing Bill Gates?

17. From the time the concept of money was understood, the concepts of lending and borrowing came into existence. But the concept of banking wasn’t there. However, the organized way of lending and borrowing happened when the prototypes of modern banks were established some 700 years ago. Banks undertook another service i.e. the remittance service. Thus, what the banks did viz., borrowing, lending and remittances, came to be known as banking. Banking is what a bank does. Or banks are those who do banking. Our Banking Regulation Act says so.

18. The mega trends that we discussed have redefined banking and banks. Actually it is not redefinition, but de-definition. Banking is no longer what a bank does; it is also what a non-bank does. Banks are no longer those entities who do banking exclusively; now others, the non-banks also do banking.

19. Chunking of banking is the norm; and for undertaking each of these chunks, there are some specialist entities who undertake only those chunks. Payment service providers,

P2P services, P2B services, (SME financing), consumer retail financing, disintermediation, crowd funding, open ended mutual funds, money market mutual funds, deposit alternatives, trade financing, invoice financing, bill discounters, bill collectors, credit referrals, account aggregators, interest free products, syndicators, investment bankers, MFIs, co-ops, HFCs and credit raters are some of the entities who chipped away chunk after chunk of banking. Is there an element of banking that remains the exclusive privilege of banks? Sadly no. That's why Bill Gates said what he said – "Banking is necessary, but banks are not".

20. How this happened? Admittedly, it is the technology and the customer expectations which chunked away or which enabled chunking away the different elements of banking.

Will banks really cease to exist?

21. That's a moot point. At least, as the PWC research report says "While we are not looking at the end of banking, we are surely looking at the end of banking and banks as we currently know them".

22. The chunking away of banking from the banks have given enormous business and growth for these non-banks. With their specialization and focussed service rendering, they are able to offer that chosen service at greatest efficiency, speed and at very affordable cost to the consumers. This has stumbled the growth of banks today and has every potential to lead to de-growth and ultimately the decimation of banks in future.

23. As we know, unconventional policies are rampant in the world. First it was low interest; then it was near zero or zero interest. People thought that zero is the lower bound and one cannot breach it. Now the lower bound has been breached and negative interest has come on the scene. Jurisdiction after jurisdiction is ushering in negative interest rate regime. Is there any lower bound for negative interest?

Can banks survive if this trend persists?

24. Another set of questions are about the justification for banks to exist. Why the society should accord the privilege of banking to banks i.e. why should there be a licensing for undertaking banking activity? Let us recall that the West no longer officially designate anybody as a bank; they have only a depository institution or a credit institution. Our FSLRC recommended Indian Financial Code also reflects similar thinking. The other day, Shri Mohandas Pai asked me, given the way the non-banks do banking, what is the justification for the banks to impose a cost in the form of the Net Interest Margin of 3% on the society. In what way rendering banking services under one umbrella is relevant any longer?

25. Yet another challenge for the banks' existence is the reaction by the society to the financial crisis – the consumer distrust in banks. Remember the movement against Wall Street? The Dodd-Frank Act? The Liikanen and Vickers Reports? The ring fencing of wholesale and retail banking? Faced with the challenge of dramatically decreased consumer trust in the post-crisis financial services market, financial institutions are increasingly acknowledging the need for new perspectives and paradigms in financial services.

26. One more onslaught on banks existence is the net effect of regulatory requirements on capital and leverage and market and public expectations on their capability to leverage their capital. Banks by definition, as we know of all these days, are the highly levered institutions. However, if we go by these factors about which just now I mentioned – viz., regulatory capital, market and public expectations – we should be dropping the definition of banks being 'highly levered' institutions. If we add the capital requirement as per TLAC prescriptions, bankers' usual cautionary additional capital, yet another add on as per the public expectation as a fallout of stress test assessments, I am afraid, we will end up banks having a debt equity ratio of about 4:1, which is not too different from highly levered corporates. That's one of the reasons why we are very cautious and hesitant about supporting TLAC whole hog.

27. Therefore, the clear prognosis is that either the banks will be dead or at least the banks of the future are not going to be the banks of yesterdays and todays.

What to do?

28. I regret that at the very end of these two days deliberations on future of banks, I have to paint such a dismal future for your existence as banks. My point is we have to recognize the realities of the day, the compulsions of the new driving forces that demand a new paradigm in banking and reflect on future course of action.

29. There are hopes. First is to take full advantage of the technological developments and enmesh in them to meet the customer expectations. The new consumer is addicted to connectivity, convenience and freedom. They want not just Value Added Services, but such services Anytime Anywhere Anyhow – so nicely said by Derrydean Dadzie the Chief Doer of DreamOval Ltd.

30. Another prescription by some like Hennie Bester, Jeremy Gray and David Saunders suggests that while banks may have the urgent need to identify new avenues for growth and the need to embrace new information-based technologies, what is of paramount importance is a positive shift towards increased recognition of the social responsibility of the financial services providers. They argue that, ultimately, balancing profitability with customer benefit must remain at the heart of any new paradigm.

31. Can you hear some ringing in the bell? The Priority Sector concept? The much touted, the much despised, the much maligned, yet rising like the Phoenix? May be yes. But I would think that this time around it is with a much larger perspective. In Financial Inclusion, Green financing, AML / CFT and even in anti-tax avoidance efforts, banks can play a much larger socially relevant role than any of the chunked away entities.

32. One big area, you vacated and / or let others to occupy by your lackluster attitude is there for your rightful reclaim, if only you make concerted and conscious effort. That is SME financing. Small and medium sized enterprises (SMEs) are a major, yet often overlooked sector by formal financial institutions. The SMEs reportedly account for more than half of the world's gross domestic product (GDP) and employ almost two-thirds of the global work force. However, they are the neglected lot world over. As reported by the International Financial Corporation (IFC), a "funding gap" of more than $2 trillion exists for small businesses in emerging markets alone. I am not going into the reasons for this state of affair.

33. In recent years, the FinTech companies and the market place lending have entered into this vacuum and have become immensely and instantly successful and have become a powerful trend. This trend has the potential to become a game changer for small businesses. Because FinTech solutions are efficient and effective, the FinTech's disruptive power is good display. If only the banks can change their current reluctant attitude towards SME financing, they can be a good antidote for these risks and therefore will display their socially relevant role, which in turn can justify their existence for the future.

34. I can only conclude with the idea that if you make yourself socially relevant, not just relevant in economic sense alone, you can have hopes to exist.

35. Thank you for your patient attention.