Shyamala Gopinath: Retail banking - opportunities and challenges

Keynote address by Ms Shyamala Gopinath, Deputy Governor of the Reserve Bank of India, at the IBA - Banking Frontiers International Conference on “Retail Banking Directions: Opportunities & Challenges”, Mumbai, 28 May 2005.

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The issue of retail banking is extremely important and topical. Across the globe, retail lending has been a spectacular innovation in the commercial banking sector in recent years. The growth of retail lending, especially, in emerging economies, is attributable to the rapid advances in information technology, the evolving macroeconomic environment, financial market reform, and several micro-level demand and supply side factors.

India too experienced a surge in retail banking. There are various pointers towards this. Retail loan is estimated to have accounted for nearly one-fifth of all bank credit. Housing sector is experiencing a boom in its credit. The retail loan market has decisively got transformed from a sellers’ market to a buyers’ market. Gone are the days where getting a retail loan was somewhat cumbersome. All these emphasise the momentum that retail banking is experiencing in the Indian economy in recent years.

What is retail banking?

Retail banking is, however, quite broad in nature - it refers to the dealing of commercial banks with individual customers, both on liabilities and assets sides of the balance sheet. Fixed, current / savings accounts on the liabilities side; and mortgages, loans (e.g., personal, housing, auto, and educational) on the assets side, are the more important of the products offered by banks. Related ancillary services include credit cards, or depository services. Today’s retail banking sector is characterized by three basic characteristics:

- multiple products (deposits, credit cards, insurance, investments and securities);
- multiple channels of distribution (call centre, branch, Internet and kiosk); and
- multiple customer groups (consumer, small business, and corporate).

What is the nature of retail banking? In a recent book, retail banking has been described as “hotter than *vindaloo*”[1]. Considering the fact that *vindaloo*, the Indian-English innovative curry available in umpteen numbers of restaurants of London, is indeed very hot and spicy, it seems that retail banking is perceived to be the in-thing in today’s world of banking.

Retail banking in India

Retail banking in India is not a new phenomenon. It has always been prevalent in India in various forms. For the last few years it has become synonymous with mainstream banking for many banks.

The typical products offered in the Indian retail banking segment are housing loans, consumption loans for purchase of durables, auto loans, credit cards and educational loans. The loans are marketed under attractive brand names to differentiate the products offered by different banks. As the *Report on Trend and Progress of India, 2003-04* has shown that the loan values of these retail lending typically range between Rs.20,000 to Rs.100 lakh. The loans are generally for duration of five to seven years with housing loans granted for a longer duration of 15 years. Credit card is another rapidly growing sub-segment of this product group.

In recent past retail lending has turned out to be a key profit driver for banks with retail portfolio constituting 21.5 per cent of total outstanding advances as on March 2004. The overall impairment of the retail loan portfolio worked out much less then the Gross NPA ratio for the entire loan portfolio.

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[1] DiVanna, Joseph A. (2004): *The Future of Retail Banking,* New York: Palgrave Macmillan.

Within the retail segment, the housing loans had the least gross asset impairment. In fact, retailing make ample business sense in the banking sector.

While new generation private sector banks have been able to create a niche in this regard, the public sector banks have not lagged behind. Leveraging their vast branch network and outreach, public sector banks have aggressively forayed to garner a larger slice of the retail pie. By international standards, however, there is still much scope for retail banking in India. After all, retail loans constitute less than seven per cent of GDP in India *vis-à-vis* about 35 per cent for other Asian economies - South Korea (55 per cent), Taiwan (52 per cent), Malaysia (33 per cent) and Thailand (18 per cent). As retail banking in India is still growing from modest base, there is a likelihood that the growth numbers seem to get somewhat exaggerated. One, thus, has to exercise caution is interpreting the growth of retail banking in India.

Drivers of retail business in India

What has contributed to this retail growth? Let me briefly highlight some of the basic reasons.

First, economic prosperity and the consequent increase in purchasing power has given a fillip to a consumer boom. Note that during the 10 years after 1992, India's economy grew at an average rate of 6.8 percent and continues to grow at the almost the same rate – not many countries in the world match this performance.

Second, changing consumer demographics indicate vast potential for growth in consumption both qualitatively and quantitatively. India is one of the countries having highest proportion (70%) of the population below 35 years of age (young population). The BRIC report of the Goldman-Sachs, which predicted a bright future for Brazil, Russia, India and China, mentioned Indian demographic advantage as an important positive factor for India.

Third, technological factors played a major role. Convenience banking in the form of debit cards, internet and phone-banking, anywhere and anytime banking has attracted many new customers into the banking field. Technological innovations relating to increasing use of credit / debit cards, ATMs, direct debits and phone banking has contributed to the growth of retail banking in India.

Fourth, the Treasury income of the banks, which had strengthened the bottom lines of banks for the past few years, has been on the decline during the last two years. In such a scenario, retail business provides a good vehicle of profit maximisation. Considering the fact that retail's share in impaired assets is far lower than the overall bank loans and advances, retail loans have put comparatively less provisioning burden on banks apart from diversifying their income streams.

Fifth, decline in interest rates have also contributed to the growth of retail credit by generating the demand for such credit.

In this backdrop let me now come two specific domains of retail lending in India, viz., (a) credit cards and (b) housing.

Credit cards in India

While usage of cards by customers of banks in India has been in vogue since the mid-1980s, it is only since the early 1990s that the market had witnessed a quantum jump. The total number of cards issued by 42 banks and outstanding, increased from 2.69 crore as on end December 2003 to 4.33 crore as on end December 2004. The actual usage too has registered increases both in terms of volume and value. Almost all the categories of banks issue credit cards. Credit cards have found greater acceptance in terms of usage in the major cities of the country, with the four major metropolitan cities accounting for the bulk of the transactions.

In view of this ever increasing role of credit cards a Working Group was set up for regulatory mechanism for cards. The terms of reference of the Working Group were fairly broad and the Group was to look into the type of regulatory measures that are to be introduced for plastic cards (credit, debit and smart cards) for encouraging their growth in a safe, secure and efficient manner, as also to take care of the best customer practices and grievances redressal mechanism for the card users. The Reserve Bank has been receiving a number of complaints regarding various undesirable practices by credit card issuing institutions and their agents. Some of them are:

- Unsolicited calls to members of the public by card issuing banks/ direct selling agents pressurising them to apply for credit card.

- Communicating misleading / wrong information regarding credit cards regarding conditions for issue, amount of service charges/ waiver of fees, gifts/prizes.
- Sending credit cards to persons who have not applied for them / activating unsolicited cards without the approval of the recipient.
- Charging very high interest rates /service charges.
- Lack of transparency in disclosing fees/charges/penalties. Non-disclosure of detailed billing procedure.

The Working Group deliberated a number of major issues relating to: a) to customer grievances and rights: a) Transparency and Disclosure, b) Customer Rights Protection, and c) Code of Conduct. The Group recommended that the Most Important Terms and Conditions should be highlighted and advertised and sent separately to the prospective customer. These terms and conditions include various issues relating to: a) fees and charges, (b) drawal limits, (c) billing, (d) default, (e) termination / revocation of card membership, (f) loss / theft / misuse of card, and (g) disclosure.

These recommendations are being processed within the RBI and a set of guidelines would be issued which are going to pave the path of a healthy growth in the development of plastic money in India. The RBI is also considering bringing credit card disputes within the ambit of the Banking Ombudsman scheme. While building a regulatory oversight in this regard we need to ensure that neither does it reduce the efficiency of the system nor does it hamper the credit card usage.

Housing credit in India

In view of its backward and forward linkages with other sectors of the economy, housing finance in developing countries is seen as a social good. In India, growth of housing finance segment has accelerated in recent years. Several supporting policy measures (like tax benefits) and the supervisory incentives instituted had played a major role in this market.

Housing credit has increased substantially over last few years, but from a very low base. During the period 1993-2004, outstanding housing loans by scheduled commercial banks and housing finance companies grew at a trend rate of 23 per cent. The share of housing loans in total non-food credit of scheduled commercial banks has increased from about 3 per cent in 1992-93 to about 7 per cent in 2003-04. Recent data reveal that non-priority sector housing loans outstanding as on February 18, 2005 were around Rs. 74 thousand crore, which is, however, only 8.0 per cent of the gross bank credit. As already pointed out, direct housing loans up to Rs. 15 lakh irrespective of the location now qualify as priority sector lending; housing loans are understood to form a large component of such lending. In addition, housing credit is also being provided by housing finance companies, which in turn are also receiving some bank finance.

Thus, from miniscule amounts, the exposure of the banking sector to housing loans has gone up. Unlike many other countries, asset impairment on account of housing finance constitutes a very small portion. However, with growing competition in the housing finance market, there has been a growing concern over its likely impact on the asset quality. While no immediate financial stability concerns exist, there is a need to put in place appropriate risk management systems, strengthen internal control procedures and also improve regulatory oversight in this area. Banks also need to monitor their exposure and the credit quality. In a fiercely competitive market, there may be some temptation to slacken the loan scrutiny procedures and this needs to be severely checked.

Having delineated the broad contours of retail banking in India let me now come to its opportunities and challenges.

Opportunities and challenges of retail banking in India

Retail banking has immense opportunities in a growing economy like India. As the growth story gets unfolded in India, retail banking is going to emerge a major driver. How does the world view us? I have already referred to the BRIC Report talking India as an economic superpower. A. T. Kearney, a global management consulting firm, recently identified India as the "second most attractive retail destination" of 30 emergent markets.

The rise of the Indian middle class is an important contributory factor in this regard. The percentage of middle to high income Indian households is expected to continue rising. The younger population not only wields increasing purchasing power, but as far as acquiring personal debt is concerned, they are perhaps more comfortable than previous generations. Improving consumer purchasing power, coupled with more liberal attitudes toward personal debt, is contributing to India's retail banking segment.

The combination of the above factors promises substantial growth in the retail sector, which at present is in the nascent stage. Due to bundling of services and delivery channels, the areas of potential conflicts of interest tend to increase in universal banks and financial conglomerates. Some of the key policy issues relevant to the retail banking sector are: financial inclusion, responsible lending, access to finance, long-term savings, financial capability, consumer protection, regulation and financial crime prevention. What are the challenges for the industry and its stakeholders?

First, retention of customers is going to be a major challenge. According to a research by Reichheld and Sasser in the *Harvard Business Review*, 5 per cent increase in customer retention can increase profitability by 35 per cent in banking business, 50 per cent in insurance and brokerage, and 125 per cent in the consumer credit card market. Thus, banks need to emphasise retaining customers and increasing market share.

Second, rising indebtedness could turn out to be a cause for concern in the future. India's position, of course, is not comparable to that of the developed world where household debt as a proportion of disposable income is much higher. Such a scenario creates high uncertainty. Expressing concerns about the high growth witnessed in the consumer credit segments the Reserve Bank has, as a temporary measure, put in place risk containment measures and increased the risk weight from 100 per cent to 125 per cent in the case of consumer credit including personal loans and credit cards (*Mid-term Review of Annual Policy, 2004-05*).

Third, information technology poses both opportunities and challenges. Even with ATM machines and Internet Banking, many consumers still prefer the personal touch of their neighbourhood branch bank. Technology has made it possible to deliver services throughout the branch bank network, providing instant updates to checking accounts and rapid movement of money for stock transfers. However, this dependency on the network has brought IT departments additional responsibilities and challenges in managing, maintaining and optimizing the performance of retail banking networks. Illustratively, ensuring that all bank products and services are available, at all times, and across the entire organization is essential for today’s retails banks to generate revenues and remain competitive. Besides, there are network management challenges, whereby keeping these complex, distributed networks and applications operating properly in support of business objectives becomes essential. Specific challenges include ensuring that account transaction applications run efficiently between the branch offices and data centres.

Fourth, KYC Issues and money laundering risks in retail banking is yet another important issue. Retail lending is often regarded as a low risk area for money laundering because of the perception of the sums involved. However, competition for clients may also lead to KYC procedures being waived in the bid for new business. Banks must also consider seriously the type of identification documents they will accept and other processes to be completed. The Reserve Bank has issued details guidelines on application of KYC norms in November 2004.

Some random thoughts

How do we see the future of retail banking? What are the major attributes of the shape of things to come in this sector? Let me share with you some of my random thoughts.

First, customer service should be the be-all and end-all of retail banking. The other day a document released by the British Bankers Association, entitled *UK Retail Banking Manifesto: addressing the challenges that lie ahead for the industry and its stakeholders* on September 29, 2004 came to my notice. This document analysed the key policy issues relevant to the retail banking sector and highlighted the role of financial inclusion, responsible lending, access to finance, and consumer protection. It is in this context that that one is reminded of the needs to develop the standards and codes for banking. The contribution of the Committee on Procedure & Performance Audit on Public Services (CPPAPS) (Chairman: Shri S.S. Tarapore) has been invaluable and has provided great insight. Based on the recommendation of the CPPAPS, the Annual Policy Statement for 2005-06 announced the decision to set up an independent Banking Codes & Standards Board of India on the model of the mechanism in the UK in order to ensure that comprehensive code of conduct for fair treatment of customers is evolved and adhered to. The codes and standards, together with the institutional mechanism to monitor them, are expected to enhance the quality of customer service, to the individual customer in particular. The codes will bring about greater transparency in the system and also tackle the issue of information asymmetry. The Board would function as an industry-wide watchdog of the banking code and ensure that the banks comply with the banking codes. The codes would establish the banking industry's key commitments and obligations to customers on standards of practice, disclosure and principles of conduct for their banking services. The Board will monitor compliance with the Codes by the affiliated banks.

Second, 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.

Third, 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.

Finally, retail banking does not refer to lending only. In the whole story of retailing one should not forget the role played by retail depositors. The homemaker, the retail shop keeper, the pensioners, self-employed and those employed in unorganised sector - all need to get a place in the banks. It is in this backdrop that the Annual Policy for 2005-06 pointed out issues relating to financial exclusion and had announced that the RBI would implement policies to encourage banks which provide extensive services while disincentivising those which are not responsive to the banking needs of the community, including the underprivileged. Furthermore, the nature, scope and cost of services need to be monitored to assess whether there is any denial, implicit or explicit, of basic banking services to the common person and banks have been urged to review their existing practices to align them with the objective of financial inclusion.

Conclusion

There is a need of constant innovation in retail banking. In bracing for tomorrow, a paradigm shift in bank financing through innovative products and mechanisms involving constant upgradation and revalidation of the banks' internal systems and processes is called for. Banks now need to use retail as a growth trigger. This requires product development and differentiation, innovation and business process reengineering, micro-planning, marketing, prudent pricing, customisation, technological upgradation, home / electronic / mobile banking, cost reduction and cross-selling.

While retail banking offers phenomenal opportunities for growth, the challenges are equally daunting. How far the retail banking is able to lead growth of the banking industry in future would depend upon the capacity building of the banks to meet the challenges and make use of the opportunities profitably. However, the kind of technology used and the efficiency of operations would provide the much needed competitive edge for success in retail banking business. Furthermore, in all these customers' interest is of paramount importance. The banking sector in India is demonstrating this and I do hope they would continue to chart in this traded path.

Thank You.