Tapping the Unlocked Business potential in Indian Financial Services

(Speech delivered by Ms. Usha Thorat, Director, CAFRAL, at the Annual Finance Conclave organised by S.P. Jain Institute of Management & Research (SPJIMR) on January 12, 2013)

Dr Sesha Iyer, Director, Mr Suresh Lalwani, faculty and students of the SP Jain Institute of Management and Research, ladies and gentlemen.

I am extremely happy to be here this afternoon grateful to inaugurate this conclave on unlocking the potential in the banking and financial services industry.

The global crisis has generated a debate on the relationship between finance and growth, always assumed to be positive. A view is emerging that, beyond a level, finance can be detrimental to stability and therefore to growth itself. Finance is good as long as it contributes to the real economy, to the society. The question asked is -what is the optimal size and structure of the financial sector for any economy? Having seen the harmful effects on the economy /society of significant drop in the value of financial and real assets during the crisis, what lesson should emerging and developing economies draw from the crisis?

In countries like India, there is significant scope, even in financially well-developed regions and sectors, for finance to contribute to growth. Penetration of formal finance is low in many regions, sections of population, rural areas and we need more finance if we have to realize the potential for growth. At the same time, finance can create asset bubbles and exposure to unproductive activities. Optimal growth of finance - financial institutions, financial markets, and financial products - to meet the objectives of real economic growth, stability and equity is an important issue for policy makers.

The extent of penetration of formal financial sector in savings, loans, insurance, pension, remittance and payments services, varies. While 60 percent of adult population have a bank account, 55 per cent have access to some form of formal credit, 1 percent have a demat account, 20 percent of those insurable have life insurance and only 10 to 12 percent are covered by any formal social security system for old age. The share of the informal sector in remittances is estimated to be sizeable although due to improvements in the payments system of late, it is said to be coming down.

Looking at the degree of penetration, there is a huge opportunity for the formal financial sector to grow and contribute to the real sector merely by achieving greater outreach and meeting the unmet demand that is currently being met by the informal sources. Formalization of the financial sector is a public policy objective because it is considered safer, fairer, transparent, less exploitative, as it is better regulated. So the first challenge for the financial services sector is to meet the existing demand effectively and efficiently.

The next challenge is to meet the potential demand.

What then is the potential for financial services in the next decade?

To answer this, I would like to draw from various research reports especially McKinsey:

- The last decade in India has seen the advent of retail banking, growth of the new private sector and foreign banks, emergence of universal banking, banks and non-banks competing for similar segment of customers, IT driven access to products and services, and focus on inclusive banking.

- The next decade will see a young population with median age of 30 in 2025, rising share of working age population expected to exceed 50 per cent of total population in 2025, increase of over 11 million to the work force each year for next five, dependency ratios to remain low till 2040 and India to account for 25 percent of global work force by 2020. This is going to be the decade of the largest opportunities in India. Households with incomes of over Rs.50, 000 per month will grow to 82 million by 2018 from 34 million currently. 40 million households will move out of the less than Rs.2, 000 per month income category. There is resurgence in rural India. The estimate is that there are 40 million middle and high income households in rural India.

- Indian corporates are becoming global and their demands for financial services are also growing exponentially. They expect highly competitive and efficient services that link with their businesses. The scope for infrastructure financing is also growing .The growth in incomes is driving the demand for more and better infrastructure services as also a willingness and ability to pay for such services.

- Over the last decade, Asian banks accounted for 47 percent of global banking revenue and delivered 20 percent of total shareholder returns. McKinsey Global Banking Pools estimate that in the next decade, Asian banking revenues will account for the bulk (45 percent) of growth in global banking revenue. According to their study, the eight drivers of growth will be the opportunity offered by the middleweight cities, multiple channels of access, shifting role of branch, lower IT costs, electronic payments, unbanked or underserved MSMEs and infrastructure financing.

- The study has identified geographies in India surrounding 14 urban centers as fastest growing and the potential lies in catering to the fastest growing markets within these geographies. It has also identified the potential and growing market of digital high value consumers. The country has 122 million internet users expected to increase to 350 million by 2015 and accounting for 35 to 45 percent of the savings. The smart phone will become the dominant access point for such customers. Of the internet users, 27 million are potential “digital high value consumers”, young (20 to 45 years of age) living in eight top cities with monthly income of over Rs.50, 000/-.

- In short, young India, urban agglomerates, rural rich, SME, corporate India and infrastructure offer the potential for financial services in the next decade

So what are the challenges for unlocking this huge potential?

The first challenge is obviously the efforts required by the industry itself in providing mass retail customers, products and delivery channels that are safe convenient and user friendly. The industry needs to differentiate rather than clone, find its own unique strengths and comparative advantage to be able to offer something that is going to be a winner. The banking industry, in particular the PSBs, have to seriously look at their staffing, technology and business processes to optimise the best of human and machine power. They have to increase the sales productivity through IT, innovation, better processes and execution. Products need to be tailored to different categories of customers such as young India, pensioners, rural markets, traders, SME, etc. Banks have to ensure that they build a strong institutional culture that will endure even when there is change in the top management team, and this is important for public sector banks, where change in top management is quite frequent. It is important to imbibe a sense of values and mission across the bank, which is reinforced in the business objectives and performance evaluation.

The second challenge is the size and structure of the Indian banking system. The global discussion on size and structure surrounds SIFIs, separation of banking and investment banking, move away from universal banking to simpler business models. The challenges in the Indian context are whether growth of large Indian banks considered systemically important should be curbed through measures such as higher capital, or we should deal with the risk of 'too big to fail' institutions in a different manner to ensure financial stability? Compared to their global counterparts, even the largest Indian banks are small. Even if all the banks are taken together, the needs of some of the largest industrial groups in India exceed the combined exposure limits. Thus consolidation of banking and entry of new banks are at the centre of the discussion on optimal size and structure. The role of foreign banks, the role of public sector or State intervention in banking, universal banking, role of small community banks, the role and regulation of non-banking financial companies and cross border financial flows are all are matters that are being re-visited afresh following the crisis. These call for extensive research and cross country comparison. For a talk on the Founders Day of Karnataka Bank in February last year, I tried to assess the performance of old private sector banks which are relatively small and regional in character and larger national banks using various parameters. It was apparent that the smaller regional banks have not been able to hold up to the competition; they have lost market share and their outreach is not as much as their larger national counterparts. On the other hand, several non-bank players have proved to be nimble footed, serving niche and smaller segments competitively while ensuring solvency and soundness and higher rates of growth compared to the banking sector. We do need banks of significant size that can meet the needs of the infrastructure sector and we do need banks and non banks to provide services to such a pluralistic society as India.

The third challenge is the regulatory environment. The global regulatory environment is moving towards more capital, capital buffers, rejigging the basis for calculation of risk especially in the trading book and for counter party exposures, liquidity requirements to control mismatches, maximum leverage ratio as back stop, central reporting and clearing / settlement of all trades in what is collectively called Basel 3. As a member of the global banking system, India has to fall in with these regulations, but there is national discretion in several areas. While framing our regulations, we have to be mindful of the fact that considerable part of the sector is outside the purview of formal finance and that regulation should not be such that this segment grows, rather there should be incentives to come within the scope of regulation. In this context it is worthwhile exploring the linkages between the formal and informal financial markets. Similarly regulation has to be mindful of the fact that in India unlike in US, the financial sector is bank centric, with the dominant share of financial assets with banks. Hence, banks will continue to have to undertake maturity transformation for some time. A constant review of the regulation is needed so that we strike the right balance between stability, innovation and growth. Supervision needs to ensure that banks conserve capital by adoption of better risk management practices, better manage and control the NPAs, undertake appropriate risk and cost based pricing, ensure that performance incentives are aligned to risk adjusted return over longer periods and raise new capital at the right time and amount.

In this context, it is very often asked as to how the banking sector will be able to grow at the same rate as in the past when the return on capital will be reduced due to the tighter regulatory regime. A stronger and more stable system with higher penetration and competition will lead to reduction in the cost of both equity and debt. There are still unexploited areas which can be penetrated where the informal markets still are dominant and this potential needs unlocking. Banks that are considered better capitalized, and having credible disclosures will be valued better by the markets and they will be able to source funds both equity and debt at lower cost.

The fourth challenge is in ensuring the fiduciary role played by the banking and financial services industry and the issue of ethics in this industry. This is all about responsible finance - which is imperative especially in the insurance and capital markets segment and in retail banking. Even though we tend to say that in India, such things do not happen, there have been three instances in the last five years where there have been evidences of mis-selling and even irresponsible finance. These are in the areas of ULIPs, derivatives and micro finance. Hence ensuring fiduciary role and responsibility is important. Reputation risk is a major risk in this industry. Trust, once destroyed, is very difficult to rebuild and hence building business with trust and responsibility is key in this as in any customer centric sector. As the financial sector grows, consumer protection and financial literacy become even more important as also mechanisms for dealing with customer complaints and grievances. The issue of ethics also raises the very important areas of core corporate values and reputation, governance, disclosure, transparency, credibility in managing conflicts of interest, competence of board directors and senior management.

I have raised the issues and challenges and hope you will debate and discuss them in this academic conclave. I congratulate the faculty and students of the SP Jain Institute for organizing this conclave and attracting such a large gathering of professionals academics and students for this discussion.