CAFRAL
CENTRE FOR ADVANCED FINANCIAL RESEARCH AND LEARNING
Promoted by Reserve Bank of India

Mass Retail Banking - Key Learnings from Cross- Country Experience

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Background

CAFRAL had organised a Mass Retail Banking Roundtable on October 3-4, 2013 which was attended by 15 bank CEOs and 6 regulators from 8 countries. The objective of the roundtable was to get Bank CEOs and regulators from different Asian and African countries to share, discuss and ideate on the opportunities and challenges of having a sustainable banking proposition for the mass retail market consumer. Many countries across the world have already seen the spread of banking to this segment through a combination of facilitative regulatory policies and innovation by banks in customising their business models to address the specific needs of this segment. As a preparation to this Roundtable and also as a follow-up on the discussions held, CAFRAL had interactions with many banks, service providers and regulators (including those who did not participate in the Roundtable) to discuss and learn about the various initiatives/business models being adopted in various countries to tap the mass retail banking opportunity.

This note is a summary of learnings that CAFRAL has gathered through these discussions and also through internal analysis of publicly available data.

Size and scope of this segment

Mass retail market, consists of 2 sub segments – the self-employed or the micro/small businesses (between US$10,000 to US$ 200,000 annual turnover) and the employed, who are primarily in blue collared jobs or working in small enterprises (between US$ 1000 and US$ 12,000 annual household income). This is a large segment with more than 1 billion people across emerging markets, and constituting anywhere between 20-40% of the total banking revenue pools. This is distinct from the 'un-bankable' segment that can best be catered at least in the initial stages only through a subsidization route or as a social obligation. Mass retail market segment is lucrative enough for a sustainable banking proposition without any subsidies. However, the fact is that about 50-60% MSME's in emerging markets are unserved or underserved (Source: IFC/World Bank MSME database 2011).

The traditional banking models have failed to penetrate this segment and the main reasons for that are:

- This segment comprises “first time customers” for banks with neither a history of credit behavior nor formal savings.

- This business requires the banks to have the ability to manage “high volume, low value” transactions.
- Accessibility is critical and the reach and distribution model of the banks have not adequately touched this segment.
- This segment is perceived to be more risk prone due to personal emergencies (health, death) or due to external shocks (natural calamities, economic downturn).

- The profitability model for this segment needs to be differently calibrated keeping in mind the unique requirements of this segment.

There are many examples of banks across many countries that are successfully tapping this segment. What emerges as a common trend across different approaches adopted by different banks is that there is need for a customized business model for tapping this segment which would include a tailored approach with respect to the following:

- Channel strategy (deep penetration with dedicated branches, multiple use of ATMs, tie-up with agents, simplified mobile banking applications)
- Simple products with standardized pricing to address the specific needs of this segment
- Differentiated HR practices and policies (community based hiring, passion for the mission, objective and measurable performance metrics, transparent compensation and incentive structure)
- Risk Management approach has to be tailored to this segment through use of surrogates for evaluation of credit risk, creating innovative ‘collaterals’ (e.g. matrimonial bed in Kenya or occupancy rights in Indonesia) to using ‘social pressures’ (e.g. local priest as guarantor) and gathering “market intelligence” from the community and opinion leaders.
- Pricing and costs. The profitability of this business is determined by large volumes. Overall loan pricing, margins and cost to income ratios tend to be higher than other banking segments.

Section I – Business Models adopted by banks for mass retail banking

Different banks have adopted different models of having the mass market franchise as a separate vertical or a s an autonomous subsidiary.

- BRI in Indonesia has a single organization for all corporate and retail customers but a distinct microbanking vertical with its own branches/outlets and dedicated staff. This dedicated micro banking vertical is 100% self-funded i.e. the savings/deposits from micro banking clients fund the loans to the micro banking clients. All loans below US$ 10,000 are handled by micro banking branches and thus there is no overlap in customer base between different verticals of the bank. Each branch is a profit centre with a defined break-even period and incentive structure is linked to the performance of the branch. Bank Danamon in Indonesia also follows a "bank within a bank" model and has created an autonomous vertical for mass market with a distinct brand, dedicated branches, people, processes and policies to suit this segment.

- There are also examples of Brac Bank setting up a subsidiary focused on financial inclusion through mobile banking while Hatton National Bank is setting up a micro-banking subsidiary with all product capability for this segment (savings, loans, remittances, etc.). The motivation of these banks to set-up a subsidiary has been to get the right focus and appropriate cost structure for the specialised business and also attract other experts as investor partners in the company. In case of Bank Danamon, the vehicle finance and equipment finance business was conducted through a subsidiary that sold its assets to Bank Danamon through an arm's length arrangement for funding purposes. The finance company vehicle gave them better repossession rights than the bank entity and was therefore the preferred vehicle.

- BDO Unibank is a large universal bank in Philippines and it operates with a single brand and single entity philosophy but has dedicated divisions for different segments. One of the reasons that they have not considered a different entity for this business is that the market in Philippines is not large enough to warrant it but in larger countries like Indonesia and India it may be more relevant.

- Equity Bank in Kenya is a commercial bank focused exclusively on mass retail banking. It offers the complete range of assets and liability products and has the largest customer base in Kenya and a 57% share of the country's bank accounts.

Whether the mass market business is housed in the same legal entity or not, it is evident from the experience of various banks that the mass market franchise requires a different culture and operating focus. Different country regulators have a different approach on whether or not banks are permitted to set-up subsidiaries and in what form and for what purpose. However, from a bank's perspective the imperatives to consider in deciding which approach to take is as follow:

- The size of market and ambition of the bank for this segment would be crucial. If it's expected to be a major contributor to the overall book and profits, then a dedicated approach would be necessary.
- The "bank within the bank" approach provides the benefit of having a dedicated focus and autonomous strategy for this segment along with the synergy with the rest of the bank (common IT, treasury, risk and compliance, etc.) It also provides a less punitive corporate governance structure (no need for separate board as in case of a subsidiary).
- The subsidiary structure provides complete autonomy and focus, distinct identity (may connect better with the target segment) and cost effectiveness (especially where it is not possible to create different cost structure within the bank itself). However, one of the challenges in setting up of subsidiaries is how is this entity funded – does it accept deposits and/or raises wholesale funds independently or has liquidity support arrangement from the parent? The other challenge is how to avoid any overlap and confusion with the customers, in terms of what business is handled by the parent and what is handled by the subsidiary?

Product strategy for mass retail segment

- **Savings:** There are banks like BRI and Equity Bank which are completely funding their lending to mass retail segment through savings from this segment. Based on their experience one in every five or six customers with a savings account would also take a loan. The discipline of regular savings actually reduces their need to borrow for their known and regular requirements. To be successful in garnering savings, the following are essential:

    - Accessibility – The bank must be present (through a branch, agent, or ATM) in very close proximity of the client and the customer must have the convenience to deposit/withdraw at any time (branches with extended working hours in early morning and late evenings in line with local community requirement, shop owners as agents providing "round the clock" access, mobile banking to facilitate transfers, remittances, top-ups).

- Pricing – This segment is not very sensitive to interest earned on the deposits (in most countries interest of 1-2% is paid on the savings account) but it is important to eliminate hidden costs of formal savings in the form of travel cost (if the bank is far) and opportunity cost (if money is not accessible all the time or if there are restrictions like minimum balance, limit on number/value of transactions).

- Trust and security – Branding and creating goodwill amongst the community is essential to win the trust of the customers.

- **Loans:** Credit is an essential requirement and a core component of a mass retail banking strategy. There are broadly two kinds of approaches followed by banks in pursuing the credit strategy:

  - Community based relationship driven model – This is a high touch model with dedicated branches and / or agent outlets in close proximity of customers and based on in-depth assessment of the customers' cash flows, assets, reputation and capability through multiple formal and informal sources.

> Bank BRI in Indonesia has a dedicated micro-banking vertical (bank within the bank) with a network of 5019 BRI Units (small branches) and 2002 Teras (like extension counters of BRI Units which are placed within the wet markets of Indonesia to cater to the micro/small business owners in the market). Each BRI unit offers both loans and deposit products and the location is carefully chosen based on the business potential in close proximity. There is a detailed mapping done of Potential Prospective Customers (PPC) to assess the total business potential. The credit due diligence for each customer is carried out using the 5 Cs principle – character, capacity, capital, condition and collateral. The staffs at BRI units have knowledge of local culture and neighborhood, which helps them gather market intelligence on the character and capacity of the prospective customers. The proximate location of the BRI Unit/Teras helps maintain constant contact with the customers.

  - Analytics based model – Commoditized, simple, non-differentiated product for savings, loans, insurance and remittances using score cards, analytics, portfolio approach driven centrally with front line sales force or distribution channels through mobile, ATMs, agents and branches. The focus here is on advanced analytics on the cash flows of the customer (through history of bill payments, remittances, and savings), proper segmentation of customers and creation of predictive models. The customer is first inducted into the use of formal payment systems through a prepaid card, bill payment service, salary cards, or savings account.

BDO Unibank in Philippines does extensive analytics using its internal data generated from cash management services, bill payment service and joint loyalty programs (with biggest retailer) and creates income proxies and consumption proxies. The focus of the analytics is on deposit velocity (movement of money) and not on deposit balance. Based on this analytics, they arrive at credit limits for their customers.

Commercial Bank of Africa in Kenya in collaboration with Safaricom offers M-shwari product. The credit limit for a short term loan (30 days) under this is determined by the bank solely on the basis of the mobile phone usage data (top-ups, money transfers, airtime usage, etc.) for that customer it receives from Safaricom. The bank has USD 61 mn outstanding in M-shwari and its non-performing assets are 3.2%.

Cignifi is a start-up which helps financial service providers estimate the credit risk of prospective customers based entirely on an individual's mobile phone usage patterns.

- **Products mandated by regulator:** Many countries have followed the approach of mandating certain products to be offered by all the banks and driving targets for their achievement. While this approach certainly helps in creating better focus on the product on a system-wide basis and results in a rapid adoption by banks, it takes away the strategic thinking from the banks. For sustainable induction of customers in the formal financial system, banks need to adopt a comprehensive strategy to engage them continuously based on their needs and convenience. The regulator needs to therefore provide the ecosystem to encourage more banks to adopt mass retail banking as a core strategy and not just a compliance requirement of offering certain products. (See Section II for details of the approach taken by the Central Banks in various countries).

Outreach strategies for mass retail banking

Banks are using multiple channels for outreach based on factors of cost, access and convenience. One estimate provided was that if we assume the cost of a transaction carried out at a branch to be $1, then the same transaction on an ATM would cost 26 cents, 15 cents through an agent and only 8 cents through mobile banking. Thus the spread and use of different channels have been optimized by various banks differently to balance business effectiveness and cost efficiency.

Branches: This channel is the core element of a retail strategy, but also most expensive. In order to make this channel cost effective the following elements are incorporated:

- Branch location is carefully chosen based on business potential and clear mapping of target customers in the vicinity. A detailed zoning exercise ensures that the potential coverage area of the branch is demarcated.
- Branch set-up is simple and staffing is kept lean based on identified tasks to be performed and the expected volumes.
- Each branch is a profit center with a well-defined break-even period.
- Branch performance is tracked using multiple objective parameters such as volume of savings, volume of loans, customer service quality, compliance/audit score and profit.
- The pricing and design of products is centrally determined but customer selection decision is decentralized at the branch.
- Staff performance is measured through productivity parameters (no. of customers per employee, no. of transactions per cashier, no. of new loans sourced, etc.) and incentives are linked to overall performance of the branch, to ensure team work.
- Ambience of branch is kept in sync with local landscape so as not to inhibit the mass retail customers.

A typical mature unit of BRI Indonesia looks as follows:	
Average number of employees	7
Average income (annual) (USD)	499,840
Average cost (annual) (USD)	271,040
Average profit (annual) (USD)	228,800
Number of loan customers	~ 1100
Number of deposit customers	~ 6000
Average loan portfolio of a unit (USD mn)	~ 1.9
Average savings portfolio of a unit (USD mn)	~ 2.2
Average ticket size (loan) (USD)	~ 1750
Average ticket size (deposit) (USD)	~ 370
A unit typically starts with 4 employees. The number of employees increases as the business of the unit grows. An accounts officer typically serves 400 borrowers, a teller takes care of an average of 250 daily cash transactions, and the customer service desk, on an average, takes care of 150 book transactions daily. As the unit grows beyond numbers that can be served by 11 staff members, it is split into 2 units.	

Use of agents: Many banks across countries have used this channel effectively to increase penetration and reach. In India, the use of agents (BC model) has not been a very successful experience due to the following reasons:

- Technology service providers setting and executing the strategy including engagement of sub-agents, where the bank did not take clear ownership.
- Lack of adequate skill, knowledge and training to the agent to perform the banking functions expected from him.
- Lack of adequate compensation to the agent to motivate him to perform the functions with responsibility, continuity and loyalty to the bank.
- Lack of adequate infrastructure with the agent such as connectivity, cash management, etc.
- Management of risks associated with the agent.

There are some successful examples from other countries where bank has used agent network to reach the last mile and provide ubiquitous access to its customers. Technology is the key driver in the success of the agent model. The other factors crucial to the success of this model are:

- <u>Selection of agents:</u> Shop keepers, who are successful in their core business, enjoy the trust of the community, have a large cash inflow in their business and are already familiar with providing credit to the customers for their purchases, were chosen to be agents of the bank. These selection criteria ensured that the shop keeper had the requisite skill and understanding to connect with the customers and also see the banking opportunity to do effective cash management for him. His cash inflows are used for customer withdrawals/loan disbursements/remittances and he gets paid for that, as also gets additional footfall. In Philippines, pawn shops have been used as agents by banks as they already have a natural interest and connect with the customers.

- <u>Ownership by the branch:</u> Each bank branch has an Agency Manager who is responsible for certain number of agents in its vicinity. He takes complete ownership of their requirements and training just as he would of the staff.
- <u>Infrastructure:</u> Each agent is provided a POS and mobile phone by the bank to ensure smooth transaction flow.
- <u>Compensation:</u> Every agent transaction is paid a commission on a per transaction basis. The bank pays them adequately and it’s still beneficial to the bank as it is cheaper than the branch and ATM channel.
- <u>Role of the agents:</u> The agent channel is primarily used for transaction processing close to the doorstep of the customer and the face of the bank and responsibility of new customer acquisition continues to remain with the branch.

- Support by the bank: The cash deployed for the business is that of the agent and the bank does not take any exposure on the agent. However, in order to provide liquidity support to the agents, the bank has entered into tie-ups with distributors of large FMCGs for cashless distribution to the retail shop keepers.

Equity Bank is the largest bank in Kenya by number of customers (8.5 million) and it has actively pursued the agency banking strategy to expand its outreach to customers in remote areas. It has a network of 213 branches, 7146 agents, 621 ATMs and 4500 PoS terminals. The objective is to provide access to financial products and services at a point nearest to the customer. The agent network reduces cost of travel and time for customers to access the bank branches and at the same time provides a much more cost-effective channel to the bank to handle high volume of low-value transactions. Typically, an Equity agent is a small business owner which can provide convenient access (both in terms of location and time) to the customers. At an agent location, a customer can open a new bank account, withdraw and deposit money, pay utility bills and purchase mobile airtime of any telco. The transaction at the agent location happens either through the mobile phone or debit card. The agent is paid a commission of about 30 cents per transaction. The agents therefore serve as 'human ATMs' and relieve the branches of the transaction load. The cost of the agent channel to the bank is therefore less than that of an ATM as the bank need not invest in the capital expenditure for the ATM. At the same time the commission from the bank is attractive enough to the agent to motivate him to provide good service.

GloboKas is a banking agent network manager that partners with banks to scale up agent banking (something like the corporate BC in India dedicated to doing agency banking only). Through its "KasNet Agent" network in Peru, agents equipped with point-of-sale devices connect to a satellite network, which allows its partner banks like Mibanco and BBVA Banco Continental, to reach more than 7000 localities throughout the country. The transactions that can be done at the agent location are deposit and withdrawals, credit card payments, funds transfers and utility payments.

Mobile Banking: Mobile is an even cheaper channel relative to ATMs and agents and is easily accessible by all. In countries such as Kenya and Philippines which allowed a telco-led mobile payments model, the transaction volume through mobile has been very high. But there are issues faced with this model: the mobile has been used only for money transfers and not as a tool to offer complete banking products. Therefore, sustainable financial inclusion through opening of savings and loan accounts has not happened through the telco-led model. The other big challenge faced is the lack of cash management capability of the telco agents. Mobile banking is clearly seen as a game changer with banks significantly investing in making this a telco agnostic platform for its customers. The foundation should be the bank account with the mobile capability as an enabler.

Bkash Ltd. in Bangladesh is a subsidiary of BRAC Bank with Money in Motion LLC, USA, and International Finance Corporation as equity partners. Bkash offers mobile wallet service through a telco-agnostic platform, which can be operated on any simple low-cost mobile phone. bKash built its own distribution network and recruited agents nationwide. After 27 months of operation it has 75000 agents, which is on an average more than one per village in rural Bangladesh, and has the highest market share of mobile transactions. Majority of bKash retail agents are small grocery shops. The revenue from the customer is split between the agents (almost 85%), mobile network operator for providing the connectivity and rest is retained by the company. bKash also earns interest on the customer balances it holds. Another innovation it has done is that it also provides its customers to use the network of Brac Bank ATMs through the mobile phone. The key features of this model are: It is a bank-led telco agnostic model. The customers and agents belong to the bank (subsidiary). It provides a competitive edge to negotiate the best rates with the various telcos especially in a market where there is no single dominant player. It provides access to incremental customers, which the bank would not have been able to reach through other channels. There is no loan product being offered presently and there is a cap on the balance that can be kept in the wallet.

M-shwari is a new banking product from Commercial Bank of Africa (CBA) for M-PESA customers, that allows them to save and borrow money through their mobile phone. M-Shwari is operated entirely from the mobile phone and cannot be accessed through a CBA branch. The M-Shwari account can then be used to transfer money from and to the M-PESA account, save and borrow. There is no minimum balance required on the deposit account and the transaction size could be as low as 1 Ksh. Interest on the deposit balance is between 2% -5% p.a. based on the balance. In one year since its introduction, the bank has acquired over 5 million deposit customers aggregating to USD 312 mn. The loan product is a 30 day micro-credit product for emergency requirements that does not carry any interest, but a one-time up-front charge of 7.5%. The loan limit is decided on the basis of the previous M-PESA (at least 6 months') and Safaricom transactions. This loan can be rolled over at an additional charge of 7.5%. It has 3 million borrowers with an outstanding of USD 61 mn. There is a revenue share arrangement between the bank and Safaricom. Losses on loans, if any, are borne by the bank only. Commercial Bank of Africa is primarily a corporate bank and this product provides it easy access to a new segment of customers. It provides an opportunity to Safaricom to monetise its M-Pesa customer base and provides them access to formal banking products.

Telenor (a telecom company) acquired a majority stake in Tameer Microfinance Bank in Pakistan in 2009. The bank offers branchless banking service through mobile across the 21000+ Telenor agent network under the brand "easypaisa". The investment from the telecom company gave the bank unparallel distribution and outreach and has resulted in significant growth. However, in this model it is mandatory to be a Telenor SIM user.

POS terminals: This is another channel with a lot of potential with many innovations taking place – integration with mobile phone, biometric authentication for security, high speed of transaction processing. However, the key reason preventing its growth is inhibition of merchants to adopt this for payments due to tax reasons.

Credit Risk Management

The overall asset quality experience of the banks operating in this segment has been positive with non-performing loans being in the range of 2.5% to 4%. The key success factors in ensuring good portfolio quality are:

- Strong due-diligence at the time of origination
- Regular monitoring and contact with the customer or visibility of his cash flows so that early warning signals can be picked up.
- Use of technology (sms alerts, reminder calls) for timely follow-up before due date for payment.
- Some banks even offer a small incentive for successive on-time repayments.
- Willingness to rehabilitate/restructure customers in genuine distress. Those borrowers who face problems due to event risks such as sickness, fire, economic downturn, etc. would be prone to borrow from other informal sources. This would make the borrower even more vulnerable financially. Instead if the bank follows a more flexible approach and permits the restructuring of the loan to tide over the difficult phase, then the probability of repayment to the bank would improve significantly and the customer stickiness would also be better. In order to take this approach the bank should look at provisioning at a portfolio level instead of an individual loan level based on the historical performance of the portfolio. This segment of customers are more prone to see these kind of event cycles and therefore a rigid approach to classify non-performing assets based on a time-bound manner would result in damaging the loan performance.

Some banks operating in this segment, adopt the following approach:

General provision made on the outstanding loan portfolio in the range of 3-5% which is in line with the expected losses budgeted for. This provision amount is fine-tuned every year based on historical performance of the portfolio. Actual write-off is done on days past due basis like for unsecured loans 100% write-off after 180 days, for secured loans it could be after 365 days. In case of genuine and temporary distress to customer, early restructuring should be done within 90 days of first default. Such restructured loans would continue to be treated as standard assets, if repayments are received as per revised schedule.

- Part of the incentives to the staff is paid at the time of repayment of the loan and only part at the time of origination.

Reputation Risk

The trust and goodwill of the bank is extremely crucial in establishing a connection with the community. Most banks run CSR and community development programs in close integration with their business operations, and directly serving the same people they are prospecting as customers. Word of mouth opinions play a big role in developing the image of the bank and every complaint tends to be amplified much more than a good deed. The bank must therefore proactively manage complaints and constantly communicate and respond to all queries from customers.

Customer Protection

Across the globe, the regulators and supervisors are turning increasingly intolerant of unfair market practices adopted by the market participants. We have seen large amounts of penalties levied on banks by the regulators mainly for failing to protect consumers' interests and for unfair practices. In fact, there is a growing feeling that the banking regulators/supervisors have proved ineffective in checking these unfair practices and failed in protecting consumers effectively. This has culminated in creation of separate authorities for enforcing fair market conduct and for protection of financial consumers. This transformation has happened in the Netherlands, in South Africa, in Australia, in the UK and several other jurisdictions. The key elements of customer protection are:

1. Pricing should be free but non-discriminatory, risk-based, competitive and value added.

   The pricing for the loans varies across countries, business models and types of loans. It is therefore important that the regulatory focus is not on stipulating caps on interest rates (as this would discourage banks from serving this segment) but more on ensuring transparency, fairness and disclosures to the customers by the bank.

   As an example, the Central Bank in Philippines terms banks to be engaging in hazardous lending if: "Loan rates are excessively higher than market rates to compensate the added or higher risks involved. Excessively higher interest rates are those characterized by effective interest rates that are 50% over the prevailing comparable market median rate for similar loan types, maturities and collaterals".

2. Transparency of charges and terms and conditions to the customer

The regulator in Peru has done simplification and standardisation of client contracts (defining standard terms and clauses, stating minimum information that must be disclosed) that must be used by financial service providers. In addition, there is also a requirement to make an affirmative disclosure to client about risks involved (what are the consequences if you cannot afford the loan, etc.) and get a confirmation from the client that he has understood it.

3. Preventing over-indebtedness

One effective way of handling this is to do tight monitoring of supply side data of indebtedness. Various elements can be built-in to make this work – specify debt capacity, mandate an assessment of repayment capacity at the time of origination, have credit bureaus, make the credit bureau information and analysis widely available, specify that the originator can do sell-down of loans only up to a certain proportion and not all.

In South Africa the National Credit Regulator prohibits reckless lending/over lending by stipulating an "affordability test" for all loans. Every lender is obliged to ensure that at the time of giving the loan, the total debt to income ratio for the customer does not exceed 70%. In case it is later proved that this "affordability test" was violated by the lender, then the lender must write-off the loan with no recourse to the borrower.

In Peru, the regulator has mandated that all regulated entities must contribute data to credit bureau. In addition, the regulator has also mandated that the credit bureau data must be used at the time of origination and there is a penalty if the same is not done. For loans that are given beyond the debt service capacity of the borrower, there is a higher capital charge stipulated by the regulator.

4. Grievance redressal

Consumer Financial Protection Bureau was set up in the US post the recent mortgage crisis and one of their first initiatives was to set-up a consumer response helpline (that is well advertised and accessible 24/7) to collect and address customer complaints. The data gathered from these complaints has been most useful in understanding and addressing where the issues are in the industry

In South Africa, the helpline of the regulator also accepts complaints regarding unregulated entities and that helps them get information about the informal sector players. In such cases, the regulator seeks the help of police to initiate action against them.

5. Financial literacy and awareness building for customers

The Central Bank in Indonesia has prescribed an obligation to provide financial education training to unbanked MSMEs, for banks who do not fulfil the mandatory lending criteria for MSMEs. Bank Indonesia also directly does significant work on improving financial literacy. However, it cannot only be the responsibility of the regulator and therefore they propose to soon introduce a policy prescribing for a certain percentage of every bank's profits to be dedicated to financial education.

People and Organisation design

Some of the constraints faced by public sector banks in India in designing an appropriate business model for tapping this segment are:

1. Very difficult to create a differential cost structure within the same bank.
2. Limited flexibility in hiring people of specific profiles or from specific geographies.
3. Mandatory nation-wide system of rotation of staff between different locations resulting in high staff turnover at the branches.
4. Cap on payment of incentives to the staff.
5. Shortage of manpower to develop a high touch model to engage this segment effectively.

Profitability

The banks operating in this segment have demonstrated that it is possible to get branch break- even in 12-15 months and business level break-even in 3-4 years with healthy returns in a 5 year time frame (ROE of 15-20%). The key drivers of profitability are:

1. Volumes: This business would make economic sense only when done on a large scale (operational expenses would see economies of scale) and high capacity utilization (more than 70% productivity levels).
2. Cost of funds: The borrowing cost of the bank would determine the margins and its ability to price competitively. Those banks with a significant savings deposit base to fund the loan book enjoy an advantage.
3. Operating expenses: Depending upon the business model and channel mix adopted the cost to income ratios could be between 50-70%.
4. Portfolio quality: Maintaining a low non-performing loans level would be crucial (up to 5% should be acceptable).

Given below are the operative numbers of an illustrative branch offereing mass retail loans (funded through wholesale banking) through the community-based model:*			
	Year 1	Year 2	Year 3
Number of Customers	331	594	634
Number of Employees	7	7	7
Numbers in USD ‘000s			
Loan Outstanding	839	1288	1457
Interest Income	88	247	308
Other Income	7	24	32
Interest Cost	32	86	107
Operating Cost (direct)	48	51	54
Overheads/allocation	28	15	15
Net Credit Loss	6	26	63
Net Profit	-19	94	102
*Source: McKinsey			

Section II – Initiatives by regulators in different countries to facilitate mass retail banking

South Africa

South Africa follows the twin peaks regulatory framework where the Central Bank is responsible for macro-prudential regulation for financial stability and the Financial Services Board along with the National Credit Regulator (NCR) oversees the market conduct for financial services. The banking license is only for deposit taking and all credit activities undertaken by the bank come under the purview of the NCR.

Consumer Protection initiatives

The Credit regulator aims to promote the development of an accessible credit market, particularly to address the needs of historically disadvantaged persons, low income persons, and remote, isolated or low density communities. The Credit regulator is also tasked with the registration of credit providers, credit bureau and debt counselors. Some of the key functions of the NCR are:

1. Regulates all retail credit agreements by bank and non-bank entities (including employers).

2. Maintains the National Credit Register in which all retail credit agreements are registered.

3. It prohibits reckless lending/over lending by stipulating an “affordability test” for all loans. Every lender is obliged to ensure that at the time of giving the loan, the total debt to income ratio for the customer does not exceed 70%. In case it is later proved that this “affordability test” was violated by the lender, then the lender must write-off the loan with no recourse to the borrower.

4. Debt Review process – If a borrower is facing financial difficulty and is unable to repay the loans, NCR reviews all the loans of that borrower and decides the restructuring arrangement proportionately for all loans.

5. Setting up recourse mechanisms through a statutory National Consumer Tribunal.

Financial Inclusion approach

The aim is the inclusion of more people on to formal payment systems, as this would give banks better ability to prevent money laundering. Some of the initiatives it took to promote this are:

1. Introduction of Mzansi account (basic bank account) for payment of social grants and benefit payments. In a five year time period from 2008 to 2013, the percentage of adults having a bank account went up from 30% to 90%. These accounts have primarily been used for transfer of social benefits and for transaction banking. Money is withdrawn quite quickly out of the account and therefore, the savings balances in these accounts are very low. In order to ensure that these accounts are not a drag for the banks, there is no interest payment for one year. Also there is an attractive compensation from the government to the bank for each social payment transaction (US$ 1.7 per transaction). The positioning of this as a basic account (for the poor) has however; made the customers more discerning and they do not like to be a “Mzansi customer”.

2. Permitting access by non-bank entities into the National Payment System, taking systemic considerations into account. Through legislation, non-bank entities such as large retail chains, IT companies, etc., that meet certain specified criteria have been permitted to receive and make payments as agents of banks, through the National Payment System. Non-bank entities constitute roughly about 20% of the total payments volume.

Provisioning norms for restructured loans

All the major banks in South Africa are following the Advanced Approach under Basle II. Hence, provisioning is not regulated but is based on internal models which are regularly back-tested. If the loan losses are found to be higher, then the banks are asked to make additional provisions by the Central Bank.

Indonesia

SME is the backbone of Indonesia's economy and comprises 97.16% of the total work force of the country and makes a 56% contribution to the GDP. However, MSME credit is less than 20% of total bank credit and the Central Bank has therefore taken many initiatives to improve access to banking by MSMEs.

Multi-tiered capital requirement

There are four categories of banks defined by their core capital.

Book 1 = bank with core capital up to 1,000 billion IDR
Book 2 = bank with core capital between 1,000 to 5,000 billion IDR
Book 3 = bank with core capital between 5,000 to 30,000 billion IDR
Book 4 = bank with core capital minimum 30,000 billion IDR

Bank within all Books must extend loan for productive financing with certain targets:

Book 1 = at least 55% from total loans or financing
Book 2 = at least 60% from total loans or financing
Book 3 = at least 65% from total loans or financing
Book 4 = at least 70% from total loans or financing

In addition, there is mandatory stipulation of lending to MSME's by all banks, in a phased manner. It has been mandated since 2005 at 5%, it will increase to 10% in 2016, in 2017 to 15%, and in 2018 to 20%.

Incentives to banks for meeting the above stipulation:

Opening branch network needs to be supported by health rating of the bank and sufficient core capital allocation based on location and type of bank branch. So capital calculation for each branch is determined by a) nature of branch (main branch, sub-branch, cash office – main branch requires more capital and others require less) and the location of the branch (country is divided in six zones based on banking penetration, branches in unbanked geographies require less capital). If a bank fulfils both the requirement of bank health rating and minimum core capital allocation, it could get additional incentives for opening new branch. For this, the bank has to give credit to:

SME – at least 20% of total credit portfolio; and/or

Small and Micro – at least 10% of total credit portfolio.

Also, if the bank does not have sufficient core capital, the central bank will still consider giving the permission if the bank meets the credit split above.

The tiered branch categories therefore incentivizes the banks to open more smaller branches in unbanked locations and also do more MSME lending.

Penalty to banks for failure to meet the above stipulation:

- Commercial Banks that do not meet the ratio of mandatory lending are given written warnings and have to fulfill an obligation to hold financial literacy trainings for unbanked MSMEs.

- If trainings are not conducted or delayed, or training activities are not reported on time, it would result in a drop in the health rating of the bank.

- If there is a drop in the health rating of a bank, the Central Bank can in its judgment reduce the limits of ownership applicable for that bank (e.g. a foreign bank can own up to 40% in an Indonesian Bank, a non-bank or corporate can own up to 30%, an individual can own up to 20%).

Interest Rates stipulation

The Central Bank does not prescribe any interest rates for lending. The Central Bank believes that through increased competition, there would be automatic price discovery. However, the Central Bank does monitor the efficiency of banks and looks at parameters such as Net Interest Margin (NIM), Cost to Income ratio, etc. and if it finds that these reflect inefficiencies in the bank, then it may make it difficult for the bank to open new branches.

NPA Provisioning and Restructuring

Loans are classified as NPA after 180 days. Banks must calculate allowance for impairment of productive asset and non-productive asset. There are two types of impairments:

1) general allowance for productive asset

2) special / specific allowance for productive and non-productive assets.

Bank Indonesia sets different levels of loans collectability:

1) Lancar **(Current)**
2) Dalam Perhatian Khusus **(Special Mention)**
3) Kurang Lancar **(Sub-standard)**
4) Diragukan **(Doubtful)**
5) Macet **(Loss)**

Non-performing loans are usually a combination of Substandard, Doubtful and Loss loans. Banks are allowed to do restructuring of loans subject to the following conditions:

a) The debtor continues to experience difficulty in repaying the loan principal and/or loan interest

b) The debtor continues to have good business prospects and is judged competent in fulfilling repayment duties after credit or loan has been restructured.

Banks cannot do credit restructuring if their goals are for:

a) fixing credit quality; or

b) avoiding the increase of allowance for impairment without paying attention to the debtor criteria as mentioned above.

Credit restructuring has to be approved by:

1) President Commissioner for the decision on restructuring

2) At least a director for the process on restructuring

If a loan is restructured before it turns sub-standard, then it is treated as a standard asset.

Sri Lanka

Some of the initiatives taken to promote mass retail banking are:

Use of agents

Banks in Sri Lanka are permitted to appoint supermarkets, post offices and other commercial outlets as agents to perform certain functions on behalf of the bank such as to collect deposits, credit card payments, and other loan installments and to act as Mobile banking (cash in/out) agents.

Payments infrastructure

License issued by the Central Bank for following classes of business:

(ii) Financial acquirer of payment cards;

(iii) Operator of a customer account based mobile payment system;

(iv) Operator of a mobile phone based e-money system

Operator of a customer account based mobile payment system:

This is a bank led model where the customers should have a bank account. All the transactions have to be routed through these bank accounts.

Operator of a mobile phone based e-money system:

These are non-bank led models. These mobile payment systems can be operated without a direct link to a bank account and hence even non- bank institutions such as telecommunication operators can operate these systems. A custodian account has to be maintained in a bank and the end of day balance has to be maintained to reflect the aggregate amount of all customer balances. There are certain limits on the cash-in/cash-out transactions. An end-of-the-day deposit balance allowed is up to SLR 10,000. Also, per transaction withdrawal up to SLR 5,000 is allowed. A wallet size up to SLR 10,000 is with minimal KYC and up to SLR 25,000 can be maintained with an additional requirement of providing sources of income.

Facilitating SME lending

Concessions on capital adequacy for lending up to SLR 200 mn where firm’s annual turnover does not exceed SLR 600 mn.

Lending to the Agriculture sector

Floor of 10% of total loans.

Expanding Access to finance

Two branches Outside Western Province for each branch in Western Province.
Common ATM switch.

Interest rate stipulation

The Central Bank of Sri Lanka has instructed banks to reduce the maximum interest rates charged for credit facilities to 24%, while the penal rates charged not to exceed 2% above the agreed facility rates.

NPA provisioning and restructuring

Loan is classified as NPA if it's in default for six months if loan is rescheduled and the borrower pays for 6 months, then the loan comes back to the standard category. If the restructuring is done before it becomes an NPA, then it is not considered as NPA.

Bangladesh

Some of the initiatives taken to promote mass retail banking are:

Increasing rural urban ratio for bank branches

From November 2012, each bank must open one new rural branch against each of their new urban branches for getting Bangladesh Bank's approval for opening new branches. Earlier the ratio had been 1:4; favoring urban branches. Apart from this, the definition of rural areas has been modified by excluding the semi urban areas, and three out of four new rural branches to be opened must be situated outside of Pourasava and only 1 of them could be situated in type C (least developed) Pourasava.

Mandatory agriculture/rural credit disbursement by all banks

In 2011, Bangladesh Bank issued a directive that each bank must disburse at least 2.5% of its total loans and advances for agricultural and rural sectors. This rate has been relaxed to 2% for initial years. The shortfall has to be deposited by the banks concerned with Bangladesh Bank at bank rate as penalty.

Micro-credit regulatory authority

In 2006, Micro-credit Regulatory Authority Act was enacted and now MRA is working as a separate authority. However, the Governor of Bangladesh Bank chairs the organization. Unlike banks, the MFIs can take deposit only from their members. However the saving volume cannot exceed 80% of total outstanding. Number of borrowers cannot be over 70% at any point of time. One third of the MFI sector investment is their borrower's savings, around 16% is soft loan from PKSF, around 17% is loan from the commercial banks, 3% from donors and the rest is accumulated surplus.

Bank-MFI Partnership

As Bangladesh Bank has made agriculture/rural credit mandatory for all banks and allowed Bank-MFI partnership for such disbursements, many banks especially the foreign and private banks having branch network predominantly in the urban and metropolitan areas and other scheduled banks with limited branch network are choosing MFIs having license from the Micro- credit Regulatory Authority (MRA) for meeting agri-credit disbursement targets. This linkage is ensuring greater access to microfinance for the farmers who were largely excluded or left untapped by the MFIs.

School Banking

Bangladesh Bank has recently advised the banks to introduce school banking activities to encourage savings behavior amongst students. This initiative is expected to facilitate financial inclusion as well as introduce the future decision makers to the modern banking technologies and services.

India

Provisioning requirements

Provision on standard assets (including Medium Enterprises) is at 0.4%. However, for direct advances to agricultural and Small and Micro Enterprises (SMEs) sectors, it stands at 0.25%.

Asset Classification norms

- A term loan is classified as an NPA if either the interest or principal repayment is overdue for more than 90 days.
- An NPA is a substandard asset, if it has remained NPA for a period less than or equal to 12 months;
- An asset would be classified as doubtful if it has remained in the substandard category for a period of 12 months;
- A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.

Upgradation of loan accounts classified as NPAs

If arrears of interest and principal are paid by the borrower in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and may be classified as 'standard' accounts

The new norms for restructuring of assets applicable from April 2015 state the following:

- The accounts classified as 'standard assets' has to be immediately re-classified as 'sub- standard assets' upon restructuring.
- The non-performing assets, upon restructuring, continues to have the same asset classification as prior to restructuring and slips into further lower asset classification categories as per asset classification norms with reference to the pre-restructuring repayment schedule.
- Any additional finance may be treated as ‘standard asset’ under the restructuring package.

<u>In the context of the discussion of the mass retail segment requiring a more flexible approach in case of genuine distress, should the restructuring norms be different for small loans?</u>