

Origination in the Indian Financial System

Aug 5, 2011

Conceptually, what is good origination?

- Providing households and firms the ability to
 - Manage liquidity (moving resources across time)
 - Manage risk (moving resources across states of the world)
- Both of the above in a smooth, convenient and affordable manner

Scope of origination

- Under-writing risk
 - KYC (regulatory as well as in spirit)
 - Product design (to deal with adverse selection and moral hazard)
- Servicing, on an on-going basis
- Information/disclosure of product & contract features
- Financial advice

Who are Originators in India?

- Scheduled Commercial Banks
- Regional Rural Banks
- Non-bank Finance Companies
- Insurance Companies & their agents
- Asset Management Companies & their distributors
- Cooperative Societies
- Post Offices
- Chit Funds
- Self-help Groups & Business Correspondents

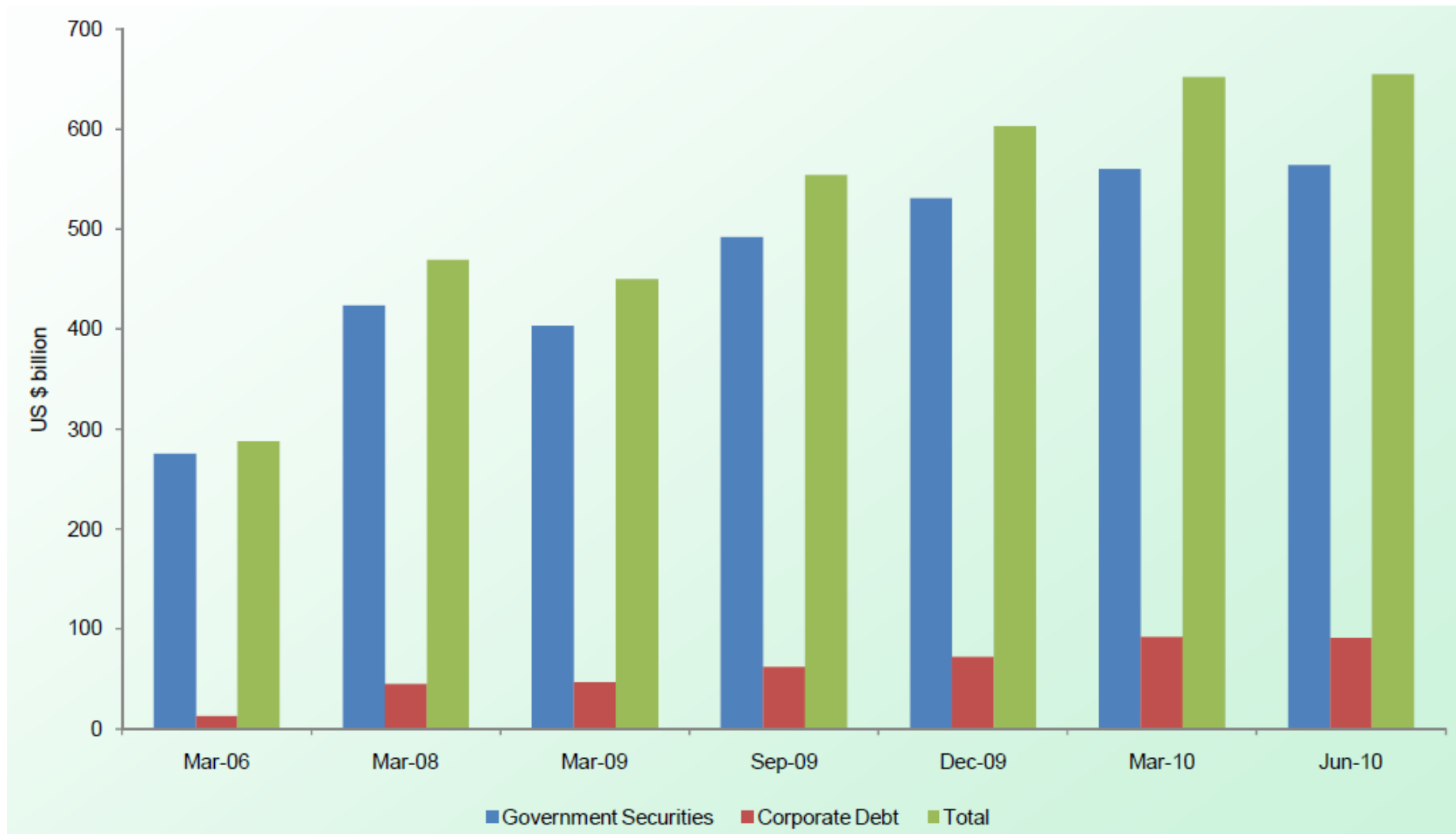
The state of origination in India

- Formal intermediation better than some countries, but still inadequate
 - Habitations in the country having a commercial bank branch: 30,000 (out of 600,000)
- Significant spatial variation
 - The N.E has less than 1500 bank branches
 - 81% of villages do not have a bank branch within a 2km radius
 - Pop/rural branch is approx: 16,000 while the same for urban is approx: 13,000
- Dominance of informal originators wrt low-income and rural hh and small firms
 - More than 50% of SME financing is from “alternative sources” (Allen et al)
- Multiple originators touching the same client

The state of origination in India

- Very poor liquidity and risk management outcomes (RBI Data)
 - Less than 50% of the population has a bank account
 - More than 50% of hh savings is in physical assets
 - Less than 4% of the population with cash savings invest in mutual funds
 - 0.6% of the population has general insurance, 10% of the population has life insurance
 - Firm access to risk management negligible
 - Nascent derivatives markets for interest rate, commodity and credit risk

Corporate debt market remains small



Most frequent events causing a financial emergency (Morduch et al, 2009)

Event	Percentage of surveyed hh
Serious injury or illness	42%
Loss of crop or livestock	38%
Loss of regular job	10%
Theft	4%
Divorce or abandonment	4%
Serious harassment by officials	4%

Kisan Credit Card Scheme – A case study of origination

- Term loan and revolving cash credit for agriculture and allied activities
 - The limit for short term loans is determined based on operational landholding, cropping pattern and scale of production credit requirement
 - Banks can include consumption expenditure based on family labour
 - Product launched in 1998 at the behest of the Government of India and annual targets set
- Total amount sanctioned by commercial banks, cooperative banks and regional rural banks (as of March 31, 2010): Rs. 4,277.48 bn (**USD 85 bn**)

Kisan Credit Card Scheme – A case study of origination

- Issues with product structure
 - No form of security required for loans up to Rs. 100,000
 - For larger loans, land used as a collateral – high loss given default
 - Flexibility on repayment. Borrowers allowed to settle the amount once a year, to become eligible for a higher limit
 - Even those failing to repay during the year are often allowed to continue, with minimal penalty
 - Under-pricing of risk (interest rate: 7%)
- No information about asset quality

Regulatory framework for originators

- Prudential regulation, entity-wise
- Similar (functionally) products regulated differently
 - Savings a/c & money market funds, loans & bonds, ULIPs & investment products
- Some product-specific regulation
 - Microfinance, credit cards
- State regulation for some originators
 - Money Lenders Act covers non-banks
- Customer protection regulation
 - Largely reliant on internal mechanisms, Ombudsman and Fair Practice Codes

Origination game changers

- The Unique ID initiative (KYC as a public good and UID = KYC)
- Innovations in payment systems (NPCI/IMPS, mobile payments, EBT)
- Elimination of economies of scale in origination

Key themes in origination

1. Increasing the outreach & 'goodness of fit' (given inherent diversity)
2. Threshold operational capability and financial strength of originators
3. Enhancing risk under-writing capabilities of originators
4. Ensuring better financial outcomes for customers

ANNEXURES

Self-reported reasons for non-purchase of rainfall insurance (Cole et al, 2009)

Insufficient funds to buy insurance	80.8%
It is not good value	7.85%
Do not trust insurance provider	5.23%
It does not pay out when I suffer a loss	2.91%
Do not understand insurance	2.33%
Do not need insurance	0.58%

[insert data on corporate bond market]

(in Rs. crores)	2002	2003	2004	2005	2006	2007	2008	2009
Government of India bonds	1,20,213	1,13,000	1,19,600	1,29,350	1,47,000	1,62,000	2,04,317	4,89,000
Corporate Bonds	4,549	5,284	2,383	66	389	594	-	3500

Source- Economic Surveys 2002-2009

Debt Market : Selected Indicators

Issuer/ Securities	Amount raised from Primary Market		Turnover in Secondary Market	
	(Rs. mn.)			
	2007-08	2008-09	2007-08	2008-09
Government	2,559,840	4,366,880	56,273,470*	62,254,360*
Corporate/ Non Government	1,162,661	1,758,267	222,273	459,110
Total	3,722,501	6,125,147	56,495,743	62,713,470

*includes NDS-OM turnover

Source: Primedatabase, RBI and NSE

Distribution of Corporate Bonds Issued by Rating

% of Total	AAA		AA		A		BBB		Non-Investment Grade	
	Number	Value	Number	Value	Number	Value	Number	Value	Number	Value
1999-00	35	83	25.9	9.4	25	6.1	7.7	0.8	6.4	0.6
2000-01	38.3	76.6	33.6	10.1	21.4	11.6	3.1	1.3	3.7	0.3
2001-02	31.7	61.6	33.5	27.8	24	9.3	7.8	1.1	3	0.2
2002-03	45.6	76	27.1	13.8	18.2	7.5	6.3	1.6	2.8	1
2003-04	50.4	77.5	24.8	14.9	17.3	6.1	6.5	1.1	1	0.4
2004-05	56.7	72.2	22.4	22	11.8	3.7	7.1	1.9	1.8	0.3
2005-06	54.6	75.1	30.8	16.7	9.4	7.8	4.4	0.3	0.8	0
2006-07	57.4	79.5	26.5	16.0	9.7	1.8	6.1	2.7	0.4	0.0
2007-08	39.5	73.1	30.3	19.4	19.7	5.7	7.4	1.5	3.2	0.3
2008-09 (4 months)	22	76.7	25.3	14.9	20.7	4.3	23.1	3.3	9.0	0.8

Audience Poll

- Originators of the future will be:
 - Integrated across multiple financial services
 - Specialised/disaggregated service providers
- Consumer protection regulation of the future will hinge on:
 - Consumer consent
 - Ex-post provider liability

Thank you