ORIGINATION

Scope

Origination may be defined as the design and delivery of financial services that provide households and firms the ability to manage liquidity (moving resources across time) and risk (moving resources across "states of the world") in a smooth, convenient and affordable manner.

Origination spans the following activities/functions: design of products to overcome moral hazard and adverse selection, establishing the identity of the customer, underwriting of risk, disclosure of all product and contract features, financial advice, and product servicing on an on-going basis.

Characterising the present state of Origination in India

Heterogeneity of Originators: Originators in India comprise a vast and diverse array of institutions including banks, non-banking finance companies, post offices, insurance and asset management companies (and their agents), cooperative societies, self-help groups and business correspondents. This is a very heterogeneous set with respect to the degree of formality and the amount of capital they represent.

Disaggregated delivery to the end-customer: Due to the product-wise organisation of service delivery and multiple product regulators, it was noted that the same household has to deal with multiple Originators in order to meet its complete need for financial services. This creates several gaps. For example, each Originator currently has its own Know Your Customer (KYC) process and this would be repeated for each incremental service availed by the household.

Dominance of manufacturer-led Origination: In the context of Origination, the conference differentiated product manufacturers (banks, insurance companies and mutual funds) from pure distributors. The latter may not "own" the financial product but are responsible for the customer interface. It was noted that Origination in the Indian financial system is dominated by a few product manufacturers with proprietary distribution networks organised along product lines with some attempt at cross-selling (ex: bank branches selling insurance products). Their distribution networks are either their own branches (as in the case of banks) or agents supervised by the principal (as in the case of insurance and mutual fund agents). In the latter model, while the principal is responsible for under-writing, agents' responsibilities are limited to sourcing clients.

Prudential regulation according to institution-type, no formal customer protection regulation: The regulatory environment for Origination entails prudential norms, largely along institutional types. Some types of product Origination (ex: microfinance, credit cards) have distinct regulatory requirements. In recent years, there has been regulatory overlap on account of functionally similar products having different regulators. The controversy regarding the Unit Linked Investment Plans (ULIP) was mentioned as a case in point. Customer protection regulation is largely non-existent, with reliance placed on internal mechanisms. There is no distinct regulator for consumer protection, with each prudential regulator framing their own guidelines vis-a-vis customer protection.

An emphasis on ex-ante financial literacy and not ex-post responsibility for the Originator: Product sale by manufacturers through agents is combined with financial literacy by manufacturers via advertising.

There are broad guidelines with respect to product level transparency and disclosure. It is largely a caveat emptor approach where the customer has to perform her own due diligence at the time of purchase and there is no recourse to either the manufacturer or the distributor for issues that emerge subsequent to purchase. Neither manufacturers nor distributors are held accountable for any outcome of financial services usage on an ex-post basis. An exception to this that was discussed at the conference is the liability on corporate bankers for sale of complex products such as derivatives, to their institutional clients.

The Report Card for Origination in India

The conference discussed Origination outcomes in terms of the two functions of liquidity management and risk management (for individuals and firms).

An important manner in which households manage liquidity is through the use of bank savings accounts and borrowings. However, roughly half of household savings are in physical assets. This is partly explained by the fact that less than 50% of India's population has a bank account. There is significant spatial variation in access to current services: not only are certain regions of the country particularly underserved (the entire North-East region has less than 1500 bank branches), but there is also significant disparity between urban and rural areas (for instance, the population per urban bank branch is approximately 13,000 while for a rural branch, that figure jumps to 16,000. Additionally, 81% of villages do not have a bank branch within a 2 km radius).

Informal Originators (moneylenders, pawnbrokers, trade creditors) dominate with respect to low income and rural households, and small firms. Such 'alternate sources' provide for more than 50% of SME financing. Even for large firms, much of their requirements are met from internal accruals and to a large extent, bank borrowings. The corporate bond market has not taken off despite repeated attempts. It stood at slightly less than 100 billion USD[1] in 2010. Almost 90% of the Indian public debt market is accounted for by government securities[2] , indicating the lack of debt issuance by financial and non-financial corporations.

Coming to risk management, the use of risk management instruments by individuals and firms is also far from ideal. Not more than 10% of the Indian population has life insurance and less than 1% has any form of general insurance. Without access to formal financial tools, majority of households face financial emergencies in the wake of events such as serious injury or illness, loss of crop or livestock, or loss of a regular job.

Firms have only lately had the opportunity to use derivatives such as currency futures (introduced in 2008), interest rate futures (re-introduced in 2009) and credit default swaps (introduced in 2011) for risk management purposes. However, there are limitations. For example, credit default swaps are available only on corporate bonds and not on loans.

Mega trends in Origination

Notwithstanding the unsatisfactory achievements in Origination, several nation-wide initiatives are now underway which have the potential to transform this landscape in India.

1 Care Ratings, BIS
2 BIS Quarterly Review, March 2008

Foremost amongst these is the Unique Identification (UID) Project which aims to provide all residents of India a single identity verification tool (based on biometric authentication) that can be easily and securely verified against a national database. Simultaneously, product regulators are taking the view that possession of a UID is equivalent to KYC. This will then make the internal KYC mechanisms of Originators redundant and effectively render this as a public good. The UID project has so far collected biometric information for 36 million people.

Another important development, and one not peculiar to India alone, is the 'digitisation' of financial and cash-based transactions. Given that the value of bank notes and coins in circulation as a percentage of narrow money is very high (60.7% as compared to 18.83% for China[3]), it is clear that India has been relatively slow in 'digitisation'. However, the development of the Interbank Mobile Payment Services (IMPS) and Electronic Benefits Transfer (EBT) systems are expected to give a fillip to this. The former aims to make possible safe and instant interbank fund transfers through mobile phones, whereas the latter will help effectively channelise government benefits (such as NREGS or pensions) to beneficiaries through bank accounts in a timely and transparent manner. Digitisation can reduce the costs of Origination tremendously, particularly in remote parts of the country where cash handling is a significant barrier.

This is concurrent with other technological advances such as the increased penetration of broadband connectivity and shared platforms for core banking technology that will facilitate cost-effective Origination. With better technology, several traditional sources of economies of scale are disappearing and creating opportunities for the emergence of small but high-quality financial institutions.

Key themes for the Future of Origination

The conference identified four themes within Origination for detailed deliberations. Below is the summary of the discussions of each thematic group.

1. Increasing the outreach and goodness of fit of Originators

There are adequate indicators to suggest that the scale and scope of Origination in the Indian financial system needs to dramatically expand to ensure good outcomes for households and firms. There is a need for new approaches to achieve this while not compromising the stability of the financial system in any manner.

The group noted the trend of non-financial distribution networks (such as mobile phone service points) expanding at a rapid pace in India and discussed ways in which Origination might leverage this network. While the obvious benefit of these distribution networks is low entry barriers, it was also noted that certain risks exist (not least that such agents bring no capability in risk under-writing and financial advice), and the manufacturer of products that involve risk-underwriting (credit and insurance) will have to completely depend on formal information (credit scores) to ensure quality.

3 Statistics on payment and settlement systems in the CPSS countries - Figures for 2009, CPSS, BIS

The group discussed the need for better information in general, both hard (credit scores) and soft (contextualised understanding of risk by local staff). It was felt that this is an important pre-requisite to expanding Origination, particularly where credit and insurance are involved. In light of the poor availability of hard information, Originators with models that leverage soft information have an edge vis-a-vis under-writing.

The group also discussed expanding the pool of formal Originators in India by allowing for formally licensed customer-facing institutions with a reasonable amount of financial capital and deep technological capability, and offering multiple services from different product manufacturers. The integration of financial services to the household (through Originators capable of dealing with multiple financial services) was highlighted as an important dimension.

2. Threshold operational capability and financial strengths of Originators

Given the considerable diversity that exists within the set of Originators in India as noted earlier, the second group tried to explore the kind of threshold capabilities - operational as well as financial - required for an entity to be a 'high-quality Originator'. This links back to some of the discussions of the previous theme. Is a village kirana or a cell phone recharge point a good Originator? How can considerations such as proximity to the client and expertise in under-writing be balanced? This group attempted to draw out objective parameters to start evaluating these issues.

Good technology capability to minimise operations risk and an ability to commit capital were two important parameters that were discussed at length.

Improvements in technology now make it possible to do real-time transaction processing, thus eliminating redundancy at the Originator-end. The growing trend in digitisation of cash mentioned earlier would also bring about reductions in operations risk for Originators (given that various aspects of safeguards presently in force as part of the cash management process would become unnecessary). This ability to operate in an automated, straight-through processing environment is increasingly going to be a hallmark of a high-quality Originator.

The group noted the need for mechanisms that ensure that Originators retain responsibility for quality of origination. Capital commitments by the Originator play an important role here. While there is a capital adequacy framework with regard to credit, there is a need to think through the role of capital when it comes to Originators of other services like insurance and mutual funds on behalf of product manufacturers.

3. Enhancing risk underwriting capabilities of Originators

Risk is created at the point of Origination and the safety of the financial system is inextricably linked to the capacities and incentives of Originators to manage risk well. This is true both when the Originator is a large bank making unsecured loans and in the context of an insurance agent under-writing life risk.

In typical manufacturer-agent approaches to Origination such as seen in the Business Correspondent approach of the RBI where a Bank appoints village level agents to open savings accounts and facilitate transactions or the Mutual Fund distribution model where an agent sells products on behalf of an Asset Management Company, the manufacturer is completely responsible for risk management. The agents' responsibilities are limited to sourcing clients. It is important to have mechanisms both at the point of selection and for on-going monitoring to ensure that the interests of the principal and the agent are well-aligned.

It was discussed that some of the ways to achieve better under-writing at the agent level include: selection of agents who have good local understanding and soft information of clients, and financial stability and capital adequacy of agents so that they can provide the manufacturer some measure of protection against operational risks and credit risk. This group again emphasised the importance of increasing the availability of hard information such as credit histories over a period of time so that in models where manufacturers are seeking to under-write directly without recourse to a local agent, they have the means to do so. That being said, the group felt that there was no good substitute to having good customer understanding, one way or the other.

The group also felt that there were several valuable lessons to be learnt from informal and specialised Originators with respect to under-writing of supposedly high-risk segments such as low-income households and second-hand truck owners. Transmitting this learning systematically across all Originators might be important.

4. Ensuring good financial outcomes for customers

This group debated how to join the various dots in Origination to ensure that it creates an environment where there is a sustained focus on good financial outcomes for customers while preventing scenarios of conflicts of interest. This group emphasised that integration of financial services is essential to ensuring good outcomes, instead of the current reality of fragmented service delivery.

The important source of conflict of interest today is the fact that the distribution channel facing the customer is often owned or significantly controlled by the manufacturer. Therefore, there is a very strong orientation to sell certain kinds of products. How do we transition to a regime where the Originator is agnostic to manufacturer considerations and is entirely driven by ensuring good financial outcomes for the customer?

This group proposed two potential blue-prints for further debate: the doctor-chemist blueprint and the medical malpractice blueprint.

The doctor-chemist blue-print would entail the following:

a. Separate the product manufacturer and the distributor; no product commissions to be paid to the distributor by the product manufacturer.
b. All sales to occur post the customer receiving independent financial advice.
c. There are strong ex-ante governance mechanisms to address potential conflicts of interest and obfuscation. For example, manufacturers would be barred from advertising their products to the customer.

The medical malpractice blueprint would entail the following:

a. The distributor could combine product sale and financial advice.
b. The distributor would receive commissions from manufacturers and fees from customers.
c. The source of accountability is ex-post liability in which the quality of the advice offered and the due process could be subject to legal review if there was a charge of malpractice.

Both blue-prints have their relative strengths. The former might be easier to implement and addresses the source of the conflict of interest. It does not however have an ex-post element that aligns the interest of the distributor tightly with that of the customer. While the latter blue-print achieves that, its weakness is that it might end up focussing disproportionately on tail events of mis-sale and could be the victim of judicial caprice, given the underlying lack of precision on what constitutes good financial advice. Due to the stochastic nature of outcomes, it may be hard to attribute responsibility to the nature of advice. One way to solve this is to develop standardised protocols for advice and hold the distributor liable for adherence to the protocol, rather than having more abstract tests. Further debate on the relative merits is required here.

Vision statement for Origination

Following the discussions along the themes described above, the conference participants converged on a vision statement for Origination.

"A financial system in which there are multiple and diverse Originators providing integrated financial services to individuals, households and firms, evaluating and pricing risks appropriately, and ultimately taking responsibility for good financial outcomes for customers."