

## The Changing Public Private Mix in Indian Retail Finance<sup>1</sup>

**Abstract:** A legacy of a long period of monopolistic government control of Indian retail finance is that public sector finance institutions continue to enjoy the lion's share of the retail finance customer base. However, private firms are making rapid progress in increasing their share of customers, and even more rapid progress in terms of their share of the aggregate financial savings involved. Comparative data from national household income and savings surveys is employed to show the degree to which this has occurred over the three years between 2004 and 2007.

Over the past two decades, the Indian government has been incrementally reopening the retail finance sector to private providers through a carefully managed process to allow public sector entities time to adjust to a more competitive environment. In tandem, increasing numbers of foreign firms are being licensed to operate in joint venture arrangements with domestic providers. As with the trend to privatise public sector business activities elsewhere, the process is being driven principally by economic efficiency concerns and to better position the country to service domestic market needs and to compete more effectively in global markets.

One legacy of the markets being largely closed to private providers for the better part of half a century following the country gaining its independence from Britain in 1947 was that the sector was managed with less regard customer service and more regard to political and ideological concerns. For public sector players, the need to engender a customer service culture is proving to be a long and arduous process. For private players, the other imperatives of establishing themselves in the market have meant that the customer service issue has not necessarily been given the priority it would have received in a more aggressive service environment. That is not to say that consumers have not benefited from privatisation in terms of improved customer service platforms and a wider range of financial products because obviously that is the case. The question is at what pace are the benefits of privatisation impacting on consumer provider preferences?

### Retail Securities Markets

At the apex of retail finance is the securities markets and in recent years equity markets have experienced a long bull run that has delivered unprecedented gains to small and large investors alike. One indicator of whether the smaller Indian investor is embracing the mantra of modern finance is the degree to which they have taken up positions in retail securities markets. In terms of a point on point increase in small investor interest, the percentage rise in interest between 2004 when stock prices began lifting dramatically and the peak in 2007 was dramatic with more than a twofold increase in the size of the aggregate small investor base. Notwithstanding, the absolute number of investors in both retail mutual funds and direct equity investors remained relatively small at some 7.3 million investors. Accordingly, small investors generally have remained cautious about entering these markets and that caution will, if anything, have been more entrenched by the prolonged downturn in the market over the course of 2008 that has seen the major stock indices fall by one third. The wider implication of this development is that for many small investors who remain inclined to attach to public sector finance providers who they see as more trustworthy custodians of their savings, that inclination may have been further reinforced.

Direct investment in securities markets however is only part of the story in India's case as access can be achieved more circuitously. According to C S Rao, Chairman, Insurance Regulatory and Development Agency "We are already witness to the

<sup>1</sup> The analysis in this paper is based on data the Invest India Incomes and Savings Survey conducted by Invest India Market Solutions (Dataworks) in 2006-07 and earlier comparable data from a national survey conducted under an ADB Technical Assistance to the Government of India in 2004.

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beneficial effects ...of competition between the public and private sector. The pension market has been developing in a big way which would benefit the large section of the people in the organized and unorganized sector. There is a thriving Unit Linked insurance market that has been generated exclusively by the private sector. The annuity market has started growing. There is plethora of new and innovative products offered by the new players.”<sup>2</sup> The fact that aggregate growth in the life insurance customer base from 23 percent of the paid workforce in 2004 to nearly 33 percent in 2007, together with the fact that Unit Linked Insurance Plans that are backed by mutual fund investments remain a market leader product means that attachment to securities markets is significantly larger than first appears.

In other words the attractions of securities markets for some small investors can be heightened through product design and more accessible sales and distribution channels of the kind offered by life insurance companies.

**Life Insurance Market**

The life insurance industry was nationalised in 1956 when the Life Insurance Corporation (LIC) was given monopoly provider status under the Life Insurance Corporation Act of India, and that remained the situation until 1999 when private players were again authorised to sell in Indian markets. While it is difficult to accurately disentangle cause and effect in the growth of the life market customer base since 1999 because rising demand for insurance would in large part have been due to high rates of economic and income growth, the fact remains that the aggregate size of the life insurance customer base has grown significantly since the sector was reopened to competition.

While India now accounts for an estimated 1.16 percent of global life premiums paid, the lion share of premium income continues to be harvested by the LIC (85.8% according to the IRDA Annual Report 2005-06). More encouraging for private insurers is that the 14 percent of aggregate premiums they managed to capture in 2005/2006 has since grown larger and more importantly they have managed that result with only some 7 percent of the aggregate customer base. Moreover, the share of customers held by private companies can be expected to continue on its present growth trajectory as demand forecasts for 2008 based on IISS 2007 survey data show

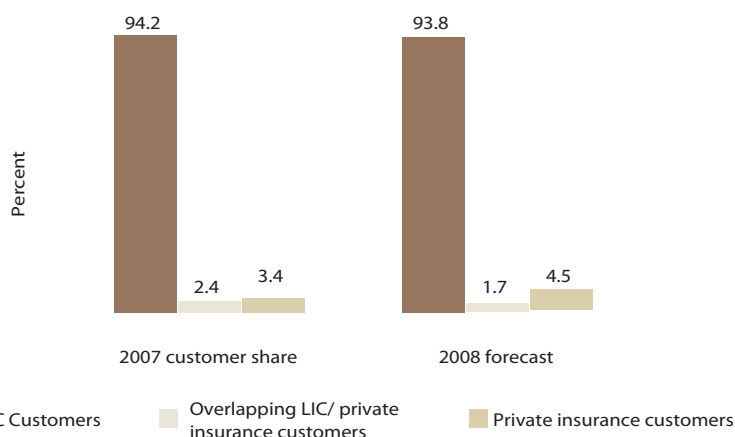
**Table 1: Percentage Shares of Customers in 2007**

Annual incomes (Rupees lakh)	LIC Customers (percent)	Customers with both LIC and private company insurance plans (percent)	Private insurance customers (percent)
< 0.5	95.8	1.4	2.8
0.5 to 1	94.7	1.8	3.6
1 to 2.5	93.9	2.5	3.7
2.5 to 5	90	5.5	4.6
> 5	83	12.2	4.7
<b>Total</b>	<b>94.2</b>	<b>2.4</b>	<b>3.4</b>

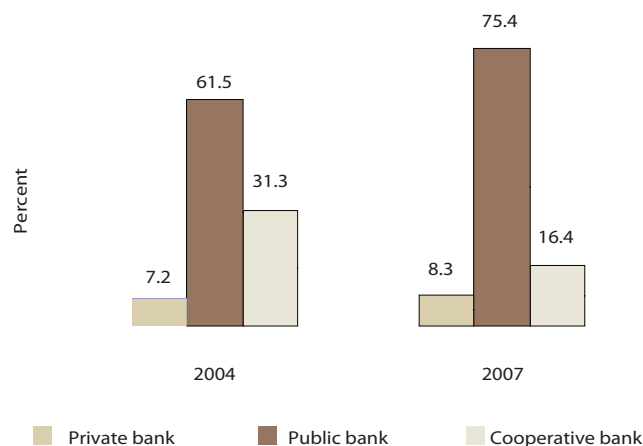
that private insurers will improve their capture rate of new business both in absolute terms and relative to LIC in 2008 (see Figure 1).

The composition of the shift towards private insurers is also important. Higher per capita premium flows for private insurers is a function of the fact that the private company customer base is more heavily skewed to higher income customers. There is also a growing group of LIC customers holding both LIC and private company insurance plans who appear to be in a transition phase in brand attachment from the LIC to private sector providers (see Table1).

**Figure 1: Demand Forecast for Life Insurance Volumes in 2008**



**Figure 2: Customer Shares Held by Private and Public Sector Banks**



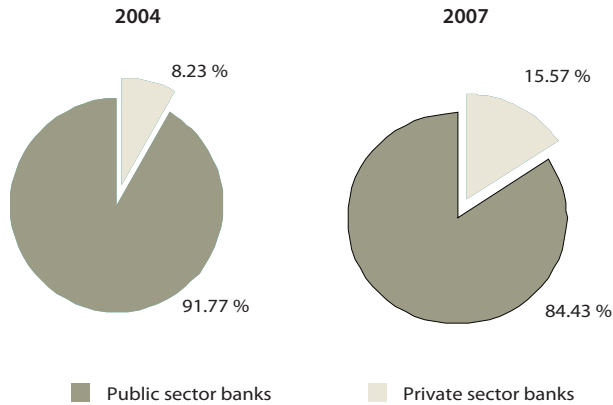
<sup>2</sup> Address by C S Rao, Chairman, IRDA, in the conference "Indian Insurance Industry: New Avenues for Growth"

**Retail Banking**

In 2007, public sector bank customers accounted for more than 90 percent of the aggregate retail bank customer base, but Figure 2 shows the gap between public and private banks is closing as in the three years to 2007 private banks increased their share of total retail customers by a full percentage point. Over that same period, the relative share of total customers held by public sector banks has probably grown to a lesser extent after allowing for customer transfers from the cooperative bank space, which has shrunk dramatically, to other public sector banks.

This outcome also needs to be read in the context of the fact that the majority of retail bank customers reside in rural India where private banks have as yet a very limited reach. In urban India the shift in favour of private sector banks has been dramatic with the private banks share of the urban customer base growing from some 8 percent of urban customers in 2004 to over 15% in 2007. In the process, the capture rate of private banks of middle and higher income groups has also improved with the middle and higher income constituency of private banks representing some 32 percent of customers in 2007 compared to some 11 percent in 2004.

**Figure 3: Estimated Shares of Urban Bank Customers for Public and Private Sector Banks in 2004 and 2007**

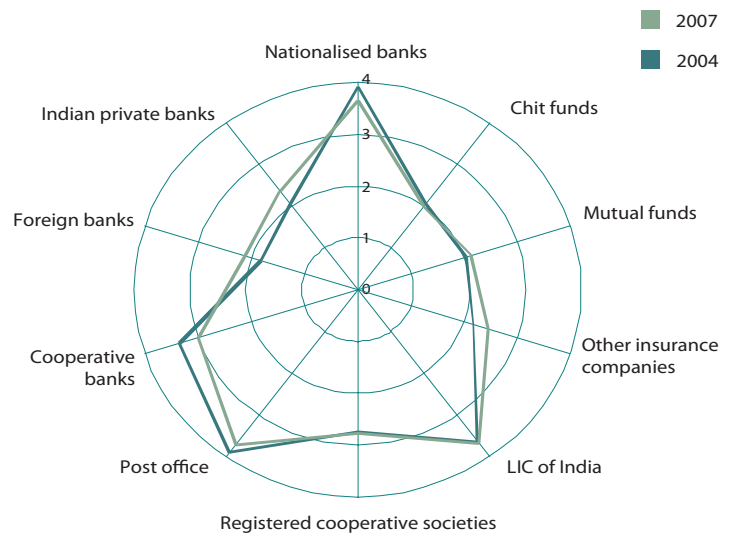


The shift in consumer attachment to private banks also has a demographic dimension with younger customers increasing gravitating to private bank usage (see Figure 4).

**Confidence Levels in Public and Private Finance Institutions**

National survey results for 2004 and 2007 show clear increases in public confidence levels in private sector finance providers across all finance sectors measured. In the retail banking space, there has been a sharp decline in confidence levels in cooperative banks and public sector banks more generally with the exception of the country's largest (public sector) bank, the State Bank of India. Interesting, India Post that offers retail bank products to its customers, and which has enjoyed very high levels of public confidence in the past, has also slipped down the confidence ladder somewhat. In the life insurance sector private players have improved their standing but LIC, unlike their public sector bank counterparts, has maintained its traditionally high confidence level enjoyed in the past.

**Figure 5: Confidence Levels on Financial Institutions in 2004 and 2007**



**Figure 4: Age Profile of Private Bank Customers**

