The Retail Dimension: Rethinking the Provision of Retail Banking Services to Low-income Communities

by R.S.K. Tucker

INTRODUCTION

How do banks carry out low-income lending when they are rapidly losing the capacity to meet with and talk to people? This is possibly the most significant question facing banks in the developing world today.

Over the last 20 years, two successive waves have enveloped the financial services industry and have brought about a fundamental shift in the way they do their business and how they relate to their clients.

The first was the drive for the most efficient deployment of capital and the consequent conversion of many mutual societies into equity-based banks.

The second was the use of technology in the drive for efficiency in order to generate the highest possible returns on the shareholders' equity.

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The result is that the definition of personal service has been fundamentally changed—but to what gain? As the world of online banking becomes ever more complex and sophisticated, returns on equity are likely to continue improving; but we risk leaving behind those whose very existence is vitally dependent on face-to-face interaction at the branch level.

THE HISTORY

Since time immemorial, the provision of credit, and most particularly mortgage finance, has been dependent on the existence of a distribution network and staff who are able to interface with their communities. This human interface underpins the origination of the loan, the education of the borrower, the borrower's understanding of his obligations and responsibilities, and follow-up if there is default.

In most Western countries this function was initially performed by a specially regulated and privileged class of institution. In the United Kingdom, South Africa and to a lesser extent Australia, it was the building society that was so privileged. In the United States it was primarily the savings and loan association (S&L). Notably, they were all mutual societies, since this was an activity driven by concern for housing for the community, and not by maximizing profit for the investor.

The institutions were given special tax and regulatory concessions on condition that they restricted themselves to mortgage lending. The result was that they developed a distribution network, expertise and culture appropriate to doing mortgage lending business, which was almost their exclusive preserve. The sole financial constraint was that the business was done at sufficient profit to be sustainable in the long term, without any injections of capital.

THE FIRST WAVE: CONVERSION OF HOUSING FINANCE INSTITUTIONS INTO BANKS[1]

However, during the 1980s market efficiency and the more market-related allocation of capital became paramount in many countries. It was beginning to be clear that the special tax and regulatory concessions that had been given to the mutual home finance institutions were resulting in distortions in the allocation of capital, and dangerous systemic risks were beginning to build up. In most jurisdictions the way was opened for the mutual societies to convert themselves into equity-based banks or to merge with banks. In some countries, including South Africa, the mutual societies were effectively forced to take that route.

As a consequence, mortgage lending became only one of the many types of business that the retail bank performed. Admittedly it was a very important part of the business done by the branch of a bank; but nevertheless there was not the same intensity of focus on mortgage lending as there had been when it was virtually the only business done by the special classes of institution.

Interestingly, some of the savings and loan associations in the U.S. did not convert to equity status or become banks, despite the shocking experience of the S&Ls during the 1980s. The fact that they survived is probably attributable to the market for securitized mortgage loans in the U.S. The S&Ls were able to carry on originating mortgage loans that were then securitized through Fannie Mae and other institutions. This enabled them to effectively earn non-interest income and maintain their reserve ratios while still doing their mortgage business.

In other jurisdictions this was not the case, and the transformation to equity-capitalized bank status, with its very different commercial logic, was completed during the first half of the 1990s. That was not all bad news, because the capital base of the equity bank did facilitate a rapid increase in the amount of mortgage business that could be carried on the balance sheet of the institution. The growth of mutual societies, on the other hand, was limited by the amount by which they could increase their reserves out of retained profits each year.

THE SECOND WAVE: THE NEED FOR SATISFACTORY ROE IN A BANK

Within the banking industry, the commercial logic that drives the business is heavily influenced by the principles of the Basle Accord. The Accord requires that a certain percentage of the assets of the bank must be held in the form of capital. Banking laws around the globe tend to be in line with these principles. By the very nature of things, this means that the bulk of the capital is held against the loans that are granted in the branches. Moreover, in most jurisdictions banks are also required to hold cash reserves against their deposit taking activities, and this, too, occurs in the branch network.

By way of example, in South Africa the makeup of the combined banks' assets at the end of 1998 is reflected in Figure 1.

Within that asset base, the makeup of loans looked as shown in Figure 2.

The result is that a banking group actually has to hold the majority of its capital in relation to its retail banking assets. A major portion of that relates to the mortgage book in particular. Similarly, the major portion of the cost of holding cash reserves and liquid assets also relates to a bank's retail banking activities.

As long as cross-subsidization was possible within a bank, this situation did not really matter. The issue was whether the bank was earning a satisfactory overall return on equity (ROE). The lower ROE on retail banking activity was effectively carried by the higher ROE generated out of the other activities of the bank.

Imputed Cost of Capital

The minimum return expected by shareholders can be estimated by using the Capital Asset Pricing Model (CAPM) which specifies the relationship between risk and required

Figure 1. Composition of Bank Assets, December 1998

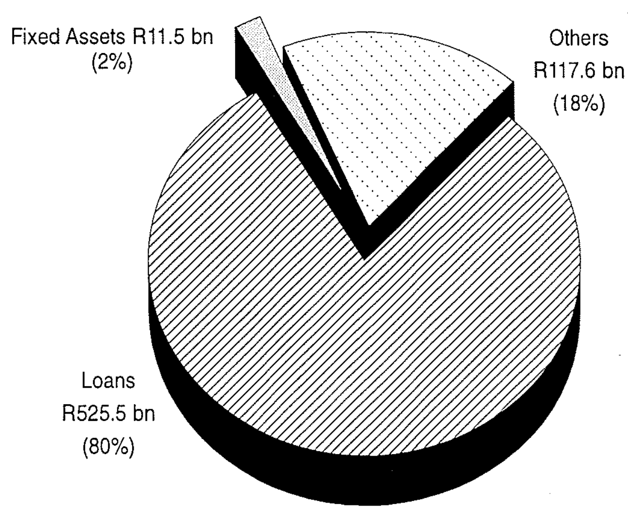

Figure 2. Composition of Bank Loans, December 1998

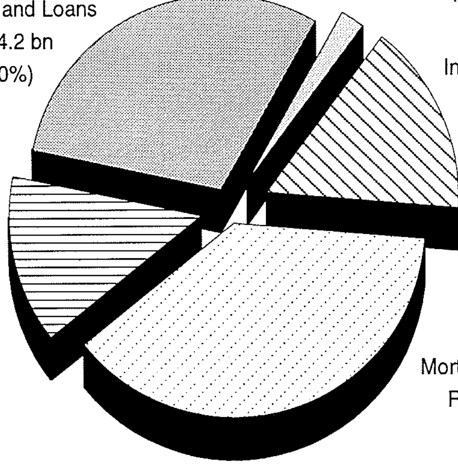

Figure 3. Returns on Equity (ROEs) for Banks Around the World*

Country	*Nominal ROE*	*Risk-free Return*	*Risk Return*
South Africa			
ABSA	19%	15%	4%
Nedcor	23%	15%	8%
Standard	18%	15%	3%
African Countries			
Ghana	75%	25%	50%
Kenya	36%	9%	27%
Nigeria	41%	14%	27%
Botswana	39%	13%	26%
Namibia	28%	16%	12%
Mauritius	14%	13%	1%
Zimbabwe	37%	42%	(5%)
Developed Countries			
U.K.	20%	5%	15%
Canada	17%	5%	12%
U.S. Supra Regional Banks	15%	5%	10%
Australia	15%	5%	10%

Source: KPMG International Banking Surveys

*By comparison, the 1998 ROEs of the major supermarket chains in South Africa exceeded 30%.

rates of return on assets when they are held in well-diversified portfolios. The calculated return is the minimum return required in order to persuade investors to purchase the share or to hold it. The return expected by shareholders equals the "risk-free" return on their capital plus the "risk premium."

The risk-free return can be regarded as an imputed cost of capital and is the minimum (but not necessarily satisfactory) return that an investor would seek without incurring risk on the actual money that is invested. For example, in South Africa in the past year, investors could have invested their money "risk free" in government bonds at a return of approximately 15% if held to maturity.

Risk Premium Attributable to Shareholders

"Risk premium" is the "profit" that the shareholders actually receive over and above the risk-free return. For 1998 that amounted to R1.7 billion in South Africa, which equals 5% of first-tier capital and reserves. This risk premium is the return for taking risk that shareholders would not have been carrying if they had invested their money in RSA stocks. According to a recent study of South African banks by KPMG, the estimated benchmark of the risk premium for the banking industry in South Africa should be between 4% and 6%. (See Figure 3.)

Although the nominal ROEs of the U.S., Australian and Canadian banks are lower than, and that of the U.K. banks is very close to those in South Africa, the interest rates on government bonds in these other countries are very much lower than rates in South Africa. Therefore, when account is taken of interest rates on government bonds (i.e., the risk-free rate) in the various countries, it becomes clear that South African banks yield a much lower risk-related return, even though their ROEs are nominally higher.

It should be noted that returns on equity are generally higher in less developed countries, and they have higher risk ratings because of high inflation, corruption and ineffective law enforcement.

The implications of this are that the South African banks, far from being too profitable, are not profitable enough. As a consequence, there is huge pressure on them to improve their ROE so as to come into line with international norms of risk-related return.

Banking Efficiency, Interest Margins and Charges

It is not that the banks in developing countries are necessarily less efficient than their counterparts elsewhere. In fact, the large banks in South Africa are generally operating at high levels of efficiency. (See Figure 4.)

Nor is it that the South African banks are achieving that efficiency ratio by charging excessive margins. (See Figure 5.)

Nor, as a matter of interest, is it that they are levying excessive charges in relation to the costs that they are incurring to do the business. (See Figure 6.)

ENTER THE NEW PLAYERS

New technologies and exposure to global financial markets has imposed a new dimension on retail banks throughout the world. Niche banks focused on high-value personal and corporate markets can be established at a fraction of the cost of full-spectrum retail banks with branch networks, and these niche banks can compete very effectively for the high-value business. Moreover, foreign banks are frequently able to bank the high-value corporate clients using the parent bank's capital base in the home country.

Figure 4. Cost-to-Income Ratios Around the World

Country	*Percent*
South Africa	57–65
USA, Canada & Australia	62–64
United Kingdom	55.5

The result is that the retail banks have had to eliminate all cross-subsidization in order to defend themselves in the high-value personal and corporate markets. As a consequence of the elimination of cross-subsidization, it has become very apparent that the risk-related return-on-equity on retail banking activity is, in most instances, probably negative.

Figure 5. Interest Margins Around the World

Country	*Interest Margin*
South Africa	3.7%
Comparable Developing Countries	
Argentina	5.0%
India	3.5%
Mexico	4.4%
Brazil	6.7%
Turkey	13.9%
Korea	< 2.0%
Colombia	10.0%
Source: BIS	
African Countries	
Botswana	8.8%
Kenya	6.9%
Ghana	10.6%
Zimbabwe	7.7%
Mauritius	4.6%
Source: KPMG International Banking Surveys	
Developed Countries	
U.S. supra-regional banks	4.5%
Australia	3.4%
U.K.	2.5%
Canada	2.3%
Source: KPMG International Banking Surveys	

So, the commercial logic as to what to do with the branch network is no longer determined by whether the institution is serving its purpose of mortgage origination at a rate of return necessary to sustain a mutual society. The issue is whether, with regard to the capital used by the branch network of an equity-based bank for all its activities (of which mortgage origination is only one), it is earning an adequate return on equity. The answer of KPMG in South Africa is that, on the basis of a careful analysis of the major banks, the ROE on capital used in branch activity is not adequate. In fact, the risk-related return is probably negative.

Please note that ROE is not a measure of where the profit of the bank is made. Frequently by far the biggest portion of the profit is made in the retail banking sector. However, if the capital is allocated to the different activities for which it is required, the return on retail banking is very low in relation to the imputed cost of that capital.

Nor is ROE a commentary on whether mortgage lending is profitable. It is. But when mixed with the other activities conducted in the branch and measured as a return on the capital allocated to those activities, it does constitute a drag on the overall ROE of the bank.

RESPONSES OF THE BANKS: CONTRACTION OF THE HUMAN INTERFACE

In South Africa retail banks have really felt the pressure, and they have had no alternative but to improve the return on equity allocated to that business. Different courses of action have been taken, such as:

- Turn the management and staff of the branches into transaction handlers and sales staff, concentrating on volume throughput and profitability. In this way non-interest income is earned, which increases the overall ROE of the capital allocated to the branch. If the origination of loans generated fee income on any scale, that would impact significantly on the branch logic as to whether to continue with that business. But in most countries loan origination does not generate any fee income of any note. It is because the U.S. institutions can originate loans for securitization and earn non-interest income by doing so that they have not seen the same erosion of their retail branch network as has been the case in other countries.

- Increase automation and convert existing branches into ATM and auto banking centers. One of the South African banks has significantly increased the number of low-income clients banked by it by converting branches into auto banking centers and getting all the clients to use card-based accounts.

- Close branches as a means of reducing costs. For example, in South Africa the four major banks had 3,820 manned outlets in 1994, which had been reduced to 3,379 by December 1998, a contraction of 441. More recently, one of the four major banks closed 100 branches in 1998. Another of the banks has indicated that it intends to close 400 branches in 1999. While this trend does not bode well for low-income people as a whole, it is important to note that it is in line with international trends, where some 80,000 bank branches are likely to close during the next five years.

Different banks have done different things; but the net result is that either the nature of the branch has been changed to a transaction and sales center, or it has been converted into an auto banking center or been closed altogether.

Figure 6. Costs and Charges of South African Major Banks

	Range of Average Costs[1]		*Average Revenues[2]*
	From Rands	*To Rands*	
Opening Costs			
Checking account without O/D	135.00	155.00	None
Traditional savings account	40.00	50.00	None
Mortgage loan	710.00	730.00	In terms of Usury Act
Monthly Maintenance Cost			
Checking account	24.00	26.00	None [3]
Savings account	4.20	4.20	None [3]
Mortgage loan	21.00	23.00	5
Teller Transactions			
Cash deposits	4.50	4.80	2.27
Cash withdrawal	5.40	5.60	5.06
ATM Transactions			
Cash deposits	9.40	9.70	1.74
Cash withdrawal			
On own bank	1.60	1.90	2.64
On other bank	1.80	2.10	6.87
Other Transactions			
Processing a check	3.60	4.00	4.25
Processing a credit-card transaction	2.10	2.30	None
Processing an EFT	1.00	1.30	2.12

Notes

1 Where applicable, costs are based on transactions of R250; transaction cost figures do not include any costs related to fraud, insurance, credit risk, Y2K systems or lost interest on cash balances.

2 All revenues are based on transactions to the value of R250.

3 An administration or service fee of up to R16 is charged on accounts on which the aggregate of the other fees is below the administration or service fee.

Source: The Banking Council

IMPLICATIONS FOR MORTGAGE LENDING TO LOW-INCOME COMMUNITIES

This is really bad news for the origination and maintenance of low-income loans, since it was that staff and those branches which were crucial in actually engaging the clients, assisting them, assessing their credit worthiness and recovering defaulted loans.

Governments around the world are relying on the existence of that network of branches. Without knowing or understanding what is going on, they are going to wake up one day to find that it does not exist and that there is no longer the network necessary to engage or get finance through to low-income communities.

This applies both to homeownership and to the financing of small and micro businesses and consumer credit.

In the case of savings mobilization and the handling of transactions, there is hope. Technology has already been shown to be a substitute (and a good one at that) for the human interface. But where a deeper and more personal interface is necessary, it is difficult to imagine how low-income, first-time homeowners will interface with the bank satisfactorily through the medium of a computer (which very few of them have anyway).

The Experience in the U.S.

It is notable that the problem with financing low-income communities in the United States of America, was not, on the face of it, the same.

First, their entire banking and savings and loan system was based on a community banking approach. Licenses were granted to operate branches in specific communities, and until fairly recently there were no national banks.

Second, because of the separation of origination from financing of mortgage loans via the market for securitized loans, the community-based banks and S&Ls have been able to carry on their businesses of originating loans, and thus earn non-interest income to maintain their ROEs at a satisfactory level.

But, despite the fact that they have a community-based banking network, they have still found that they are not able to do what is necessary for community development and "upliftment" without other interventions at the community level. This has taken many different forms and includes initiatives such as the Treasury's Community Development Financial Institutions Fund to assist with the establishment of the financial institutional capacity necessary to undertake this type of work satisfactorily. A special unit in the Office of the Comptroller of the Currency (the banking regulator) to assist with community development in areas where banks are engaged in CRA lending is another.

Despite the existence of this community-based banking system and network, and the rich mosaic of instruments, institutions and initiatives and the vast resources of the U.S. relative to the number of people in a disadvantaged position, they are still struggling to get on top of the problem.

WOULD A CHANGE IN THE NATURE OF THE PRODUCT HELP?

So where does that leave the rest of us? Most of us have a much greater proportion of our population that will not be satisfactorily served through a highly sophisticated electronic banking system. Our banking networks were never that strong anyway and are now weakening. Moreover we do not have the securitization or other resources with which to address the community development problems that haunt us.

Of course, it would help if we had a less complex product, and even better still if it were possible for someone else to do the originating for us. This is certainly an issue that we have had to confront in South Africa over the last few years.

It became very obvious that the mortgage loan was, in many instances, significantly less than an ideal form of security. It is costly to originate and difficult to understand. Moreover, because it relates to property, any form of common protest around the issue of property, its condition, or discrimination in its allocation is easily reflected in a boycott of bond payments.[2]

In fact the national housing strategy rests on twin pillars of a direct once-off capital subsidy by the government to low-income households coupled with mortgage lending by the banks. The subsidy worked well. But with a 45m2 self-standing house on a serviced site costing a minimum of R55,000, fewer than 10% of unhoused families could afford the 10% deposit (R5,500) or meet the monthly payments on a loan of R49,500. At a bond interest rate of 20% per annum, a monthly income of at least R4,000 was needed to qualify for such a loan. But anyone earning an income of that amount was disqualified from receiving a housing subsidy. Therefore, the housing strategy did not function as expected.

Nevertheless, the banks did a great deal of lending to people who could not afford the financing and quickly got into trouble, with serious consequences both for them and for the banks. There are now more than 60,000 properties in possession.

Micro Housing Loans

During this same period a market developed for micro housing loans. These loans are granted by banks in conjunction with employers. The employers perform three critical functions:

- They carry most of the burden and cost of originating the loans, and more importantly they interface with their own staff in explaining what is a much simpler product;
- They make payroll deductions and pay the monthly installments straight over to lenders; and

- They arrange pledges of employees' pension or provident fund benefits to the banks as security for the loans.

As a result, the originating costs are very low and losses, to date, have been minimal. One disadvantage is that few of the potential borrowers have pension or other benefits valued in excess of R15,000, resulting in an average loan size of approximately R10,000. Another is that as interest rates and installments are variable, borrowers, particularly during 1998, found that larger-than-expected deductions (which many could not afford) were taken off their salaries when the interest rate spiked. Nevertheless, the banks have more than R3 billion of these loans on their books. Some of the nonbank micro lenders have also been very active in this market and have probably also loaned more than R3 billion.

Altogether these micro housing loans will provide access to housing finance to another 20% of the previously unhoused market.

Recognizing the limitations of micro loans in not providing housing finance in large enough amounts to purchase a developer-built house, the National Housing Finance Corporation (NHFC) and the banks have jointly designed a new program, Gateway, to deal with this constraint. Under the Gateway program, banks and other intermediaries will originate loans in conjunction with employers (in much the same way as they do for micro loans) and then sell the loans to Gateway. Gateway is able to:

- Use the financial capacity of the NHFC to stabilise the interest rate for the borrower;

- Accept 50% security instead of the 100% backing required by the banks; and

- Raise the necessary funds by issuing bonds in the market.

Moreover, the Gateway program overcomes the problems that were initially encountered by the banks in granting small mortgage loans for low-income housing. The program is expected to provide another 10% of the currently unhoused population access to housing loans of between R20,000 and R35,000 that they would not have been able to obtain without this assistance.

THE WAY FORWARD

Despite the advances made with the development of new, simpler products and the use of the employer to handle the interface, it is clear that this is only a partial solution, and that we have to develop the capacity to interface with low-income communities in a meaningful way.

In fact, I think that in each of our respective countries we are going to have to find our own unique method of developing and building that capacity. With considerable hesitation, I would like to suggest a few general principles that might be of reasonably general application:

- Community development does not occur where the community is the object, but only where it is the subject of the initiative;

- Institution building should take place within the community wherever possible, and the end result should be a community-based, owned and managed institution;

- Governments are not good at building private sector institutions, so we will have to rely on private sector institutions to do this work;

- Private sector institutions in developing countries will no more do this type of work voluntarily than they would in the U.S. The reality is that building this community- based institutional capacity is not going to improve ROE. What is more important is that if they did do it voluntarily, it would not be sustainable. The ones that would do it would be disadvantaged relative to those that did not;

- Therefore it can only be through a close and effective partnership between the private and public sectors that the institution-building required at the community level can take place. The banks will clearly have to be the major players. But they will have to be motivated to take it on through the use of inducements necessary to make it profitable;

- Government will therefore also have a major part to play in doing this, and the U.S. is a good model of what needs to be done. Rather than simply compelling the banks, government has provided very material assistance in the form of guarantees, community building initiatives and so on to ensure that this type of lending occurs;

- Moreover, the principle of ensuring "sound banking practice" underpins all lending. Regrettably, in South Africa the point has to be made continually that it can never be considered "sound banking practice" to lend in communities where the prevailing attitude is that it is all right not to repay your loan, or to frustrate the due process of law in realizing a bank's security. So the low-income communities will themselves have to bring something to the party and share in this effort.

DEMOGRAPHICS OF THE WORLD'S POPULATION

In conclusion, we should be reminded, as calculated by Philip Harter, M.D., FACEP, Stanford University, that:

If we were to shrink the earth's population to a village of precisely 100 people, with all the existing human ratios remaining the same, it would look something like the following:

- 57 Asians
- 21 Europeans
- 14 from the Western Hemisphere
- 8 Africans
- 6 people would possess 59% of the entire world's wealth and all 6 would be from the U.S.
- 80 would live in substandard housing
- 70 would be unable to read
- 50 would suffer from malnutrition
- 1 would have a college education
- 50 would never have made a telephone call
- 1 would own a computer

We have no alternative but to work out how we are going to use the power of the market place, of capitalism and of modern technology to uplift the huge proportion of the world's population that has been left behind to live in quite intolerable circumstances.

NOTES

[1] Editor's note: For a review of mutual-to-stock conversions in the early 1990s, see the September 1994 issue of *Housing Finance International.*

[2] Editor's note: In South Africa mortgage loans are referred to as mortgage bonds. For more detailed discussion, see the articles by M. Tomlinson in the June 1998 issue of *Housing Finance International.*