

# **“The Consumer Financing Business in India” – Building Blocks for the Future**

**Authors:**

Akash Gupta ([no\\_controls@yahoo.com](mailto:no_controls@yahoo.com)) & Rahul Agarwal\*

December, 2003

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\* Former Students at Indian School of Business, Hyderabad

## **Executive Summary**

Spurred by the liberalization process, there has been a gradual move away from a supply-constrained economy to a demand-driven one. Moreover, the typical Indian consumer's mindset has changed as well. Austerity is no longer considered a virtue and debt is not a taboo any more in a typical middle-class Indian family.

The arrival of cheaper finance has completely changed buying patterns. Today the size of the consumer finance market is estimated at over Rs 70,000 crore, clocking an annual growth of over 30 percent. Seven out of ten cars are currently sold through loans. Rural markets also account for one-third of the consumer finance purchase. Cheaper and more easily available finance has enabled consumers to upgrade and buy costlier products. As a result, purchase patterns have changed significantly, and consumers are now buying higher quality goods.

In view of this changing landscape, we look at the three major drivers of growth in consumer finance: auto finance, housing finance and consumer durable finance. We discuss the trends in each of these areas as well as the shortcomings which are slowing down growth. We present some of the innovative product ideas which have appeared in the market recently and others which have the potential and can pick up provided adequate attention is paid. These include customer financing by large retail outlets, range of credit card offerings, innovations in education finance, rural finance, etc.

The role of risk management has also been discussed as far as containing delinquencies and losses in repayment of loans are concerned. The mortgage portfolio performance will get affected by a sharp drop in real estate prices, drop in rents, changes in the tax laws removing exemptions for mortgage repayments. The Auto loans portfolio can get affected by the drop in re-sale values of cars, decrease in car prices, exchange rates, etc. Unsecured products like personal loans and credit cards can get affected by macro economic factors like employment rates, inflation, interest rates etc. We therefore provide an overview of the risk mitigation strategies which are available to lenders and progress made in this direction so far.

## **Changing Landscape – boom in Consumer Spending**

There are 300 million middle-income earners in India, bringing home US\$2,000 to \$4,000 a year - much higher in purchasing power parity than that figure would indicate. Economists say that annual income in Asia of about \$3,000 is the takeoff point for car purchases. India's middle class, already bigger than the entire population of the United States, is expected to grow to 445 million

by 2006. Knight Frank India has ranked India fifth in the list of 30 emerging retail markets globally, predicting 20 percent growth for the segment by 2010.

Another evidence of the growing consumption levels is the consumer outlook survey conducted by Delhi-based KSA Technopak, India's largest management consultancy, specializing in the consumer product segment. As per the survey which is based on 10,000 four-member families with slightly higher earnings than average, urban consumers in 20 Indian cities spent over INR 15,000 crore on themselves in 2002, a 12 percent year-on-year increase.

A DSP-Merrill Lynch report said that household consumption spending in India could double to INR 25,000 billion by 2008. Ongoing demographic changes in India are poised to push consumption spending from 12 percent, observed for the last seven years, to 15.2 percent annually up to 2008. With uninhibited spending and living on credit cards, and changing products faster than ever, the Indian middle class has indeed moved from the age-old habit of functional living to a lifestyle based on an unprecedented surge in consumer spending.

<b>How Indians Spend</b> (KSA Technopak survey) <i>Percentage of annual earnings spent</i>		
	<b>1999</b>	<b>2002</b>
Groceries	46.2	42.1
Personal care	6.2	8.8
Appliances/durables	8.6	5
Clothes/footwear/furnishing	7.8	10.5
Books/music	5	6.7
Movies/entertainment	2.9	5.8
Vacation/eating out	10.8	15.6
Savings and investments	12.1	5.2

Jagdish Khattar, managing director of Maruti Udyog, comments "I am bullish about the future [of consumer spending habits] simply because consumer finance is intensifying and local levies can only go one way - down."

<b>What Indians spend most on</b> (KSA Technopak survey) <i>The age at which the maximum share of annual earnings is spent on a particular category</i>				
<b>Age 15-19</b>	<b>20-24</b>	<b>25-34</b>	<b>35-44</b>	<b>45-58</b>
Books, music, footwear	Home appliances, movies	Eating out	Clothes, furnishings, personal care	Vacations

The age profile of the Indian population is yet another bet for continued spending growth. Over 45 percent of India's population is less than 19 years, which is at the forefront of the current boom, and would continue to be so. The typical Indian is getting younger, and with that the so-called teenage trends of lifestyle and consumption, are now becoming mainstream. More and more Indians are moving away from functional life to a lifestyle of fulfillment.

### **Consumer financing – Picking momentum**

Consumer lending in India has zoomed from Rs20,000 crore in 2000- 2001 to Rs55,000 crore in 2001-2002. Finance is available for anything under the sun from TVs, washing machines, refrigerators, air-conditioners, PCs, two-wheelers, cars, to branded furniture, software, books and teaching aids. Consumer financing is now available even for air travel, holidaying and higher education. Cheaper and easily available finance is infact fuelling the growth in demand for white goods.

The National Council of Applied Economic Research reckons that the impact of consumer finance first began to be felt in 1999-00. In that year, demand for financed white goods rose 23.9 per cent while the overall market grew just 18.9 per cent. In the rural markets the availability of cheap finance was an even bigger factor in growth. While rural demand for white goods grew 22.4 per cent in 1999-00, the growth of financed white goods rose a phenomenal 39.6 per cent. Southern states accounted for 45 percent of consumer finance market and western states, 30 percent. Retail loans have grown at 27 percent per annum between 2000-2001 and 2002-2003 and commercial credit, at 13.6 percent. Growth in purchases with consumer financing in 1999-2000 was 134 percent overall in urban areas and 103 percent in southern states.

## **Auto Finance**

There are several private finance companies in India specializing in auto finance, both at the regional and national level. Apart from these companies, automobile loans are offered by most private and public sector banks. ICICI Bank disburses over Rs300 crore per month in the car financing business. It is also the largest financier in the 2-wheeler industry.

Auto loan industry is growing at 30 percent per annum. Also, consumers are upgrading their cars by borrowing from auto financing companies. Automobile finance companies tend to focus on personal automobiles, while banks cater more to commercial vehicles. Availability of financing for used vehicles is presently limited but expected to be a major driver of growth in the near future. Leasing options for new vehicles are also limited. Recently, car manufacturers have begun offering one-year interest-free loans to buyers of their cars.

Like other lending institutions in India, auto finance companies face a high percentage of delinquencies. Some of the problems facing auto finance companies in India are:

- Lending decisions are taken at the local level, and lack consistency. As local offices have to meet performance targets, they tend to lend approve marginal cases.
- Credit checks are inaccurate due to lack of information.
- Recovery from defaulters is difficult. Even repossession of automobiles limits recovery as borrowers often replace new components with used ones.
- Interest rates are high because of low recovery. This makes finance options less attractive to consumers.
- Used automobile finance and leasing of new vehicles is limited due to the difficulties in assessing consumer credibility and lack of effective recovery options.
- Automobile finance companies do not share consumer data. Consumers are often able to obtain automobile finance even after defaulting with previous such loans.

ICICI Bank has been facing a similar scenario, with many of its auto loan borrowers defaulting on the payments. It has now started repossessing the vehicles but disposing of them is a big issue. Many of these vehicles are finally getting channeled to online auctioneers like Bazee.com for sale at discounted prices.

## Housing Finance

India has several housing finance companies offering loans for construction, renovation, and purchase of residential accommodation. Recently, banks have also started offering housing finance, and are seen as significant competition to housing finance companies. ICICI Bank and State Bank of India leads in home loan segment among banks while Housing Development Finance Corporation and LIC Housing Finance leads the HFCs. Maximum number of housing loans is of the size less than Rs5 lakh with a repayment period of 10-15 years. Total loan disbursement by banks and HFCs increased by 76 percent in 2002-03 to Rs51,673 crore against a 31 percent increase witnessed in 2001-2002.

India currently faces a large shortage of adequate housing in the country. Overall, there is a shortfall of 19.4 million dwelling units in the country, of which 16 million are in rural areas. The government is initiating various programs and policies to bridge this shortage. The availability of adequate housing finance will remain a key factor in their success.

A survey conducted by the FICCI on 47 banks and housing finance companies has revealed that banks have overtaken house finance companies (HFCs) in the home loan market. Banks have netted a 65.5 percent share of the total home loan disbursements in 2002- 2003 (43.6 percent in 2001-2002). In light of this increased competition, untapped markets such as rural housing, or low income housing can no longer be ignored.

Some of the common issues facing housing finance companies in India are:

- Lending decisions are conservative and restricted to the high income group consumers due to the lack of facilities to establish credibility, and foreclosure regulations.
- Rural and semi-urban markets have remained largely untapped due to high down payment requirement and non availability of title deeds in the absence of land records in the rural areas.
- For new construction, finance is generally offered for construction only, and not for purchase of land. This makes new housing less affordable.
- Recovery of defaults is difficult due to the lack of an effective legal framework.
- Processing of loan applications is time-consuming and expensive.
- Interest rates are high because of poor recovery.
- Pricing of property and construction are inflated by consumers to get additional financing.
- Banks are able to make better lending decisions than housing finance companies as they favor their existing clients and are aware of their financial standing.

The default rate in the housing finance sector is about 1.47 percent. Recently, National Housing Bank has decided to extend the provisions of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 to housing finance companies, which are registered with it. These stipulations would bring 23 housing finance companies under the purview of the Act, including HDFC Ltd, LIC Housing Finance, ICICI Home Finance, Can Fin Home Finance, and Birla Home Finance among others. These firms can repossess houses of defaulting housing loan customers by just lodging a complaint with the police. This would thus facilitate the recovery process.

### **Retail Credit/ Durable goods financing**

India has a large consumer goods manufacturing base. It has several major players in the luxury and semi-luxury segments that boast of nationwide retail and distribution networks. A number of consumer goods manufacturers have started offering loans to consumers for purchase of their products. These loans are normally processed at the retail location level. Color televisions (CTVs), refrigerators and air conditioners, generate 80 percent of business for consumer durable financiers.

There are several finance companies that offer consumer durable finance. Countrywide Personal Finance and The Associates are two companies that have percolated to a very large number of consumer durables dealers. Apart from this, housing finance companies also offer consumer durable finance at attractive interest rates to existing home loan customers. Since repayment capacity has already been appraised by the concerned HFC, getting a consumer finance loan through this channel could be fast and easy. Some banks (both public sector and private), also offer consumer loans. These are generally offered to existing account holders of the bank. Personal loans offered by some banks and finance companies (like Citibank and Kotak Mahindra) may also be used for financing your consumer durable purchase. The eligibility criteria for these loans, however, tend to be more stringent, since no security for the loan is asked for. Also, interest rates tend to be a little higher than those for consumer finance schemes. Some of the important players in the field include Countrywide - Classic Scheme, Countrywide - Express Channel, Countrywide - Instant ATM Loans, HDFC, The Associates, ICICI, Allahabad Bank, Corporation Bank, Bank of Baroda, Central Bank, and HDFC Bank.

Issues that need to be resolved in order to boost consumer finance in this area include:

- -Manufacturer or dealer promoted finance schemes for consumer goods are an effective tool for business development, but come with a heavy price due to poor recovery. It is

also difficult to refinance such loans as the credit decisions are mostly made at the retail location level and application procedures are inadequate.

- -Credit decisions normally take a few days. This makes such finance schemes less marketable.
- -Large corporations find it difficult to implement such finance schemes nationally and seek maximum benefit.
- -Retailers are also weary of promoting such schemes locally due to the lack of means of gauging consumer credibility.

Currently, percentage of total sales accounted for by the rural buyers is 26 percent for color televisions and 22 percent for refrigerators. The rural market for consumer durables is projected to grow by 15-20 percent in 2003-2004. A recent study conducted by Francis Kanoi, a market research company based in Chennai, shows that growth of the consumer durables industry in the rural market could be affected by unavailability of consumer finance options.

### **Innovations in lending – Avenues for Growth**

Banks and finance companies have come up with various innovative products and services to lure the consumer- from 0% interest schemes, to 100% finance schemes to instantaneous loan approvals, all leading to a spurt in the Consumer Finance market in India. Banks are offering customized financing solutions by offering schemes which have 'step up' and 'step down' repayment options (monthly installment increases or decreases each year) or repayments which are Front Ended (Higher Repayments at the beginning) or Back Ended (Higher Repayments towards the end).

To cite a specific example of innovative new offerings, Dewan Housing Finance Ltd (DHFL) has recently launched a scheme, DHFL Sampoorna Rakshak (SR), that provides risk cover for three equated monthly installments (EMIs) of the home loan in case the borrower of the loan loses the job or in case of medical emergency. SR also covers the house to the extent of its construction value. The insurance covers against unforeseen disaster such as earthquake, gas cylinder explosion or fire.

### **Rural Financing**

The rural demand for financial services can roughly be divided into two segments, based on different orientation and perspectives:

- The “agricultural segment”: (Composed of farmers who make most of their living from agricultural activities) Agricultural loans finance purchase of tractors and other farm machinery, production, processing and marketing of enterprises specialized in agriculture. To deal with the price risk, lenders can make use of the available futures/Options contracts to gain information about the probable evolution of prices in the short term. Plantation of tree crops, land leveling, heavy farm machinery etc are some examples of long term loans for investments which can also be financed taking into account value of the collateral, present value of additional income generated by the investment etc.

- The “transitional segment”: (Significant portion of their income comes from non-agricultural sources like wages, rearing livestock, remittances, commerce, etc.) Rural loans generally have a variety of repayment schedules which include bullet payments (i.e. a single payment of interest and principal at maturity), loans with monthly payments of interest and repayment of principal at maturity, or even loans in which the timing and size of payments are not constant but irregular, based on the borrower's projected seasonal income pattern. Tailoring payment plans to the expected cash flows of individual households is essential for rural lending since rural clients usually have substantial income from agriculture and more diversified income sources than urban clients. SafeSave has recently launched a new rural lending product in Bangladesh which allows the clients to specify the desired maturity (which may not exceed 12 months) and pay the interest up front. Once disbursed, clients are free to pay whatever amounts they wish to SafeSave's collectors, who visit clients at regular intervals (daily, weekly or monthly).

Another subset of Multi-Purpose rural credit products are loans which are granted or rescheduled in emergency situations. Emergency loans can be used for individual emergencies such as accidents, illnesses or other individual events and disasters caused by natural catastrophes like earthquakes, draught or flooding. These include rescheduling of existing loans, grant of small and standardized loans during this critical phase to help clients cover basic needs and loans for financing repair or replacement of damaged or destroyed farm property (real and chattel) and supplies lost or damaged as a direct result of a natural disaster.

State/Central Governments have also realized the need for rural financing and have been taking steps to make it more attractive for a risk averse lender. Banks/HFCs on the other hand have been cautious of lending to farmers without sufficient security to enforce in case of defaults in repayment of dues. Many states in India propose to amend their respective legislations to enable borrowers to mortgage their farms for purposes other than agriculture. This, in turn, will give a fillip to rural housing finance as the existing legislation does not allow agricultural land as collateral for housing mortgages.

## **Innovations in Educational finance**

Educational finance in India is restricted to higher education loans by banks. These loans are typically given by banks for higher technical education at the graduate and post graduate level. However, there exists a huge demand for loans for school education. There has been a large improvement in the standard of primary education in India which has led to an increase in the basic fee of medium rung schools in urban and semi urban India. With the increasing emphasis on education, even the low income families strive to educate their children in good, expensive schools even if it is too expensive for them. Many companies like insurance companies have identified the importance of good primary education to parents and have come up with investment products which take care of the schooling years of the children of the savers. Thus clearly there exists a huge market for school fees financing in India. For example, a finance company can finance the school fees of a child for six years from class six to class twelve and receive it in EMI's over fifteen/twenty years. This would provide parents access to schools, fees of which they otherwise cannot afford. This need has not been addressed by finance companies so far and a huge untapped market lies ahead.

## **Customer Financing by large retail outlets**

Large retail stores and multi brand outlets are becoming increasingly popular in urban and semi urban India. Retail chain store like Westside, Pantaloons, Music world, Lifestyle, Foodworld are getting increasingly popular. These stores have an increasing customer base and are growing at a fast rate. Most of these stores have a huge electronic database of customers. Most of these stores also have membership programs for their customers and issue them cards to track their purchase and reward them. As more and more people from lower middle class families migrate to these stores, the demand for credit purchases have been increasing. S, there exists a huge market for financing the purchases from these big stores. Lets illustrate this with the help of an example. Lets say, on the basis of a credit check and study, Pantaloons grant their customers a credit facility on purchase on a single bill over Rs 5000. Now this Rs 5000 can be returned in 3,6,9 or twelve months , depending upon the credit needs of the customers. Now Pantaloons will get this arranged through a financing company.

This is extremely beneficial to Pantaloons as well as to the consumers. The sales of retail outlets like Pantaloons, will experience a substantial growth through this programme. This will prove to be a better source of financing than credit cards to the consumers because of convenience and

lower interest payments. Thus there exists a huge demand for financing in this segment, which will turn out to be a major growth driver for finance companies.

## **Expanding Gamut of Credit Cards**

Aided by technology and innovation fuelled by the market needs and underlying growth propositions, a wide range of credit card offerings are now possible that are structured to meet the requirements/demands/life style of consumers. Innovations in the Cards market have resulted in the evolution of the card from being a “convenient alternative to Cash” to becoming the “financial window” for lenders to offer bundled services to consumers. Some of the offerings that have become possible are:

- Co-branded Cards aimed at maximizing benefits to the Card Holder by both the issuing and Co-branding partners.
- Co-issuing for and on behalf of a partner.
- Affinity Cards representing a close user group with the benefits realized on the spend by the Affinity Group
- Installment Loans with EMI linked to Card outside the Credit Limit.
- Personal Loan linked to a Card
- Consumer Loan disbursed through a Card with a credit line equivalent to the Loan amount...The paid up installments adding to Open To Buy (OTB)
- Secondary Limits on the Cards during high spend seasons
- Hybrid products covering the features of the Card and the Loan
- Virtual Card (e-card for exclusive use on the net)
- A Card as part of the Mobile Phone SIM card for making Payments etc.

## **Risk Mitigation Strategies - Use of Credit Reporting**

The significant decrease in lending costs achieved in developed countries with the use of credit bureaus and credit scores has induced regulators and financial institutions to assess and promote the use of such instruments to enhance credit processes. Credit scoring can be provided by the credit bureaus or with information provided by these.

### **1. Credit bureaus**

Credit bureaus are public or private firms using large databases containing the history of financial transactions of individuals and firms of all economic activities. These histories are used by lenders and insurances in order to assess applications of potential clients in different ways,

depending on the lender's or the insurance's criteria which are usually reflected in scores. Credit bureaus fulfill for lenders two important functions: They allow appreciating the risk which is incurred when lending to a specific individual or firm and they help enforce the repayment of the loans. The more complete the information in a credit bureau with respect to its scope and the number of information sources, the more comprehensive the analysis which can be performed by a lender. Repayment of loans is enforced by credit bureaus by making an even temporary breach of a lending contract become public. When such information becomes public about a client, other lenders may restrict lending to him or her or they may increase the interest rate charged for loans to this individual, who is now perceived as a higher risk. The higher costs of lending or the exclusion from further lending sets for clients a strong incentive to repay loans in time.

## **2. Credit scoring**

Scoring is widely used in developed countries to assess repayment risk. It is based on the assumption, that the past performance of the different client segments is a valuable tool to predict the future repayment patterns and even loyalty to a given institution. As such, credit scoring analyses the past performance of different client segments and tries to predict future repayment based on this information. In the United States, credit scoring, based on the extensive databases and is used as the sole tool to select potential clients and to determine whom to lend and whom to reject. Scoring and additional information on the applicant's income is also used to determine loan size and to determine the interest rate charged to each client. Credit scoring is a management tool which entails assigning weights or points to bits of information and the total score of the customer is arrived at. The model facilitates a more rational approach to credit decisions and is based on portfolio behavior - it has proved to help reduce delinquencies.

Setting up a scoring scheme to predict future repayment conduct or loyalty can only be undertaken if accurate information exists for large numbers of clients over several years. Setting up a scoring scheme requires specialized expertise as the existing information has to be assessed using statistical models and mathematical forecast models have to be set up. Given the shocks and deep changes, which affect the economies in developing countries and especially their rural economies, scoring in such countries can only be used to determine the general trends in repayment behavior. It may not be used, as in developed countries, to give a forecast of the probability of default. Also, if the databases are not extensive and repayment is not being reinforced by efficient credit bureaus, the potential of scoring is more limited.

In India, Currently, banks are prohibited from sharing positive data by secrecy provisions governing their operations. Reserve Bank of India (RBI) has recommended enacting umbrella legislation, Credit Information Bureau Regulation Act, to pave the way for setting up of credit

information bureaus and easing the process of sharing information on individuals and corporate companies. A database of customer accounts is also being drawn up by the Credit Information Bureau of India (CIBIL), which can be used to spot serial defaulters. Potential users of these credit reports are:

- Banks & financial institutions
- Consumer & mortgage finance companies
- Credit card companies & other service providers e.g. mobile phones etc.

Cibil aims to provide complete and reliable credit information to its members. It has 75 members, consisting of 53 commercial banks, 7 housing finance companies and six FIs and 7 non-banking finance companies. Member institutions have been asked to submit returns of all existing non-suit-filed accounts by the end of Dec 2004. CIBIL will obtain and share data on borrowers, both consumer and commercial, in a systematic manner for sound credit decisions, thereby helping to avoid adverse selection. This would also facilitate reduction in NPAs.

## **Conclusion**

We have shown that consumer financing business in India has been on an uptrend recently and is expected to remain so in the future fuelled by the sweeping changes in the consumption habits of the Indian middle class. Till now most of the growth has come from traditional channels of financing like auto finance, housing finance, consumer durable financing etc. But going forward, banks and NBFC alike need to search for other avenues for sustaining the momentum. This growth can come from areas like developments in rural finance, widened gamut of credit card offerings, education, partnerships with Multi Brand Outlets etc. While targeting growth, financial institutions also need to be equally weary of how to mitigate the extra risk involved in exploring untapped market. This involves setting up of credit bureaus and development of credit scoring models to gauge the credit worthiness. If credit scoring coupled with credit bureaus providing in-depth databases is employed, promising results may be achieved in reducing transaction and risk costs, as lending decisions can be automated and as repayment is reinforced.