LET A THOUSAND FLOWERS BLOOM: CHANGING THE ORBIT AND SPEED OF FINANCIAL INCLUSION IN INDIA

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Why Is Financial Inclusion Important for India?

India is tipped to be a global economic powerhouse in the near future with the fast pace of GDP growth in the last decade, swelling middle class, rise in per capita income and increased urbanisation amply pointing toward this reality. While economic growth per se is a welcome feature, the policy makers need to ensure that the issue of equitable development is inbuilt in the growth story. At present, it is not with 68% of population living below $2 a day[1] and as argued by Stiglitz (2012)[2] inequality can lead to a vicious downward spiral causing instability of the political and economic system.

Access to financial services supported by other enabling measures such as skill development, investments in farm lands, financial literacy and extension services can play a vital role in bridging inequality and ensuring sustainable growth. Global development literature amply supports this link arguing that financial market imperfections, such as information asymmetries and transaction costs of dealing with the formal sector act to constrain the growth opportunities for the talented poor and the micro- and small enterprises that lack collateral, credit histories, and connections, leading to persistent inequality and slower growth (World Bank, 2007)[3]. Asli Demirgüç-Kunt, lead author of the World Bank report rightly opines that "Better access to finance not only increases economic growth, but also helps fight poverty, and reduces income gaps between rich and poor people."

The policy memo argues that while the public policy in India has always accorded high priority to inclusion, the progress has been sub-optimal on account of sole reliance on banking channel, imposition of target based approach and preferring conservatism over innovative approaches. The memo shows that enabling changes on two aspects which harness the strengths of players other than banks can change the inclusion paradigm, make it more meaningful as well as lay the foundation for more innovations.

The Access to Financial Services Policy in India: Key Changes in Approach over the Years but Predicated on the Banking Sector

The role of the financial sector has always remained crucial within India's development strategy, as lack of capital has been seen as the major bottleneck in the fight against poverty. Following the pattern in most developing countries, increasing access to credit for the poor has remained at the core of Indian planning. The assumption behind expanding the outreach of financial services, mainly credit was that the welfare costs of exclusion from the banking sector, especially for the rural poor are very high (Pande, 2007).[4]

The means of expanding access to finance however evolved over five decades and broadly followed the pattern in the macroeconomic policy. Till 2010, three stages can be discerned in the role of financial sector in expanding access to credit, each with its own theoretical underpinnings and mode of credit delivery (Fisher & Sriram, 2004[5]; Rangarajan, 2005[6]). The first phase from the 1950 to the mid-1960s relied on the existing credit structure consisting mainly of cooperative banks in rural areas and private commercial banks in semi-urban and urban areas. The second phase started with the nationalisation of private commercial banks in 1969 and lasted till early 1990s and can be considered as the most important phase inasmuch as it not only resulted in a drastically new paradigm but also created specialised institutions for rural credit.

Government intervention through directed credit, state owned Rural Financial Institutions (RFI) and subsidised interest rates during this phase increased the tolerance for loan defaults. Loan waivers by the government, lax appraisal and monitoring of loans by banks, reliance on credit through set products and collateral requirement created a two- fold problem. The institutional structure was unviable and even the penetration of credit to the poor was far from desired. This coincided with the general slump in the Indian economy caused by increasing deficit and adverse balance of payments. These twin factors led to reorientation in the economic policy as well as banking sector policy in the early 1990s. The policy response in the form of economic liberalism–the third phase-envisaged a greater role for the market, gradual easing of the social banking norms and introduction of profitability as a benchmark.

This conicided with the growth of microfinance. In India, NABARD[7] took the lead in developing the Self Help Group (SHG)-Bank linkage programmem,[8] which formed a synergistic relationship between the informal groups of poor and the banking system. Supplementing this, NABARD led model was the private sector initiative termed as "MFI model" which started with many donor funded NGOs taking up group based savings and credit activities. With growth of credit intermediation, the MFI model evolved through the years starting from separation of microfinance as a vertical and ending with transformation as for-profit entity.

Both models witnessed phenomenal growth with the MFI model outreach touching 26.7 million clients by March 2010 and SHG-Bank linkage programme covering nearly 5 million SHGs by March 2010 taking the combined outreach to a whopping 86 million (Srinivasan, 2010)[9]. Pande (2007) emphasises the underlying policy stance during post 1991 by saying that while bank outreach fell, the policy stance is to fill the gap through micro credit. However, this limited brush with alternative financial services delivery mechanism too suffered a jolt in the wake of crisis in Andhra Pradesh in 2010.[10] Overnight, the trump card of financial inclusion became a pariah and the paradigm has shifted back to a bank led approach. Though, recently the sector has again received attention by way of framing of draft microfinance bill in 2012 with the objective of regulating the sector, the outreach of MFI model fell to 19 million by March 2012.[11]

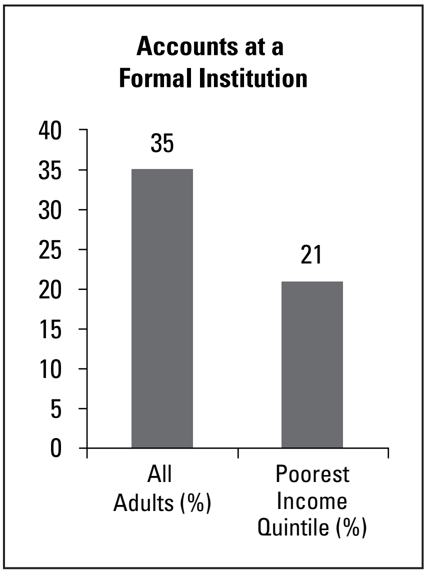
The crisis has brought attention back to the banking sector with the broad strategy for financial inclusion in India in recent years comprising of the following elements: (i) encouraging penetration through business correspondents (BCs) model (ii) use of technology to lower costs (iii) encouraging banks to open a basic banking "no frills" account (iv) emphasis on financial literacy and credit counselling and (v) asking banks to provide banking facilities in all villages with a population of >2,000. The intensity of the change is reflected in opening of 96,828 BC outlets and opening of 103 million no frills accounts by March 2012.[12]

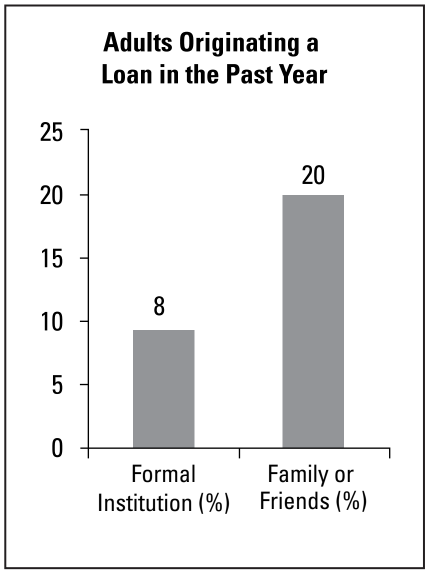
Policy Impact: State of Inclusion in India

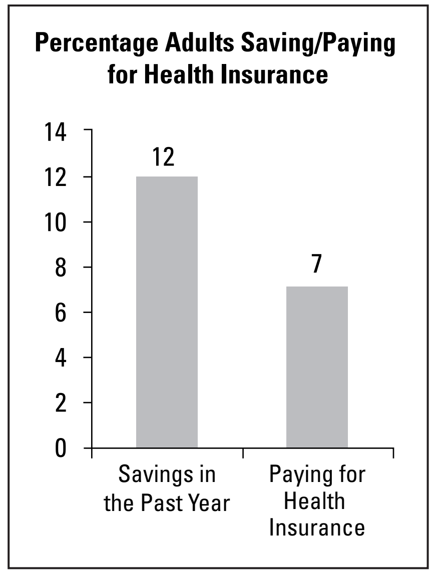
It is vital to examine the impact of above policies on the state of inclusion in India, keeping in mind that albeit for a short period the focus has remained on the formal banking sector and on credit dispensation.

The Global Findex database brought out by the World Bank[13] is one composite source and the picture which emerges tells us that the impact has been far from desired.

The above data is corroborated by Sinha & Agarwal (2011)[14] with an upward bias. As per them 47% have account at a formal institution but this falls to 27% in case of persons earning less than Rs.90,000[15] per year which is almost the poverty line. On credit side, the report finds that while 46% have taken a loan in the last three years, the share of moneylenders/friends and relatives is as high as 52%. It is clearly seen that vast majority remains excluded from savings and credit services and on account of "credit centric" approach, the situation is far more grim in case of other services such as insurance and remittances.







Factors Impeding Financial Inclusion: The "MMC" Conundrum

The policy memo argues that the mono model, mono product and conservatism [MMC] in policy stance has constrained the pace of financial inclusion in India.

Mono Model: As brought out earlier, the policy has mainly remained fixated on the formal banking sector to achieve inclusion despite evidence from the field pointing to limitations of the formal sector on account of its rigid product line lacking flexibility and innovation, complex documentation, high transaction costs associated with low volume transactions, approaching inclusion as obligation and urban mind set (Sisodia, 2005[16]; Sinha et al, 2000[17]). The Sinha & Agarwal report lists high transaction time, documentation and financial literacy as the major challenges associated with the formal sector. However, it needs to be acknowledged that this policy induced formal sector push starting with nationalisation of banks in 1969 has created a vast banking network in India with average population per branch at 13,466.[18]

Despite the obvious limitations of bank led approach, the policy push has only made banks strive to do the minimum necessary to gain approval (or at any rate regulatory forbearance) rather than tapping the vast opportunity. Policy seems to miss that unless policy imperatives/obligations like priority sector lending, having a banking outlet in every village with a population >2,000 are seen as business opportunities, the inclusion efforts will continue to be compliance based rather than being meaningful. For example, a study of no frills accounts in Tamil Nadu by MicroSave[19] showed that 64% of these accounts were inactive for more than a year and 82% were inactive for more than six months.

Mono Product: Till recently (as early as 2005) the focus remained on credit ignoring other more required financial services by the poor. Literature on the subject shows that poor people need a wide range of financial services that are convenient, flexible and reasonably priced (ADB, 2000[20]). Author's PhD[21] dissertation argues that often other financial services such as insurance and remittance are needed by the poor over credit. Mohan (2006[22]) rightly argues that access to other financial services like insurance and remittances are integral to livelihood opportunities of the poor. Even in the phase of promoting alternative delivery channels like microfinance, microfinance institutions were only seen as means of credit intermediation and not savings promotion. Though the policy stance has become more active in promoting savings by way of current focus on no frills accounts but remittances and micro insurance still remain low priority areas. Even the slight broadening of focus is not beneficial as it continues to see it from the prism of "mono model" approach.

Conservatism: Conservatism in policy is exhibited in many forms ranging from mono model approach focussing on rate of interest rather than total cost to customer to keeping costs artificially low, not allowing non-bank financial institutions to mobilise savings and limiting money transfer to be routed through banks. Aligned to this approach is reliance on "supply" with a focus on achieving measurable supply-side targets rather than satisfaction of actual customer needs.

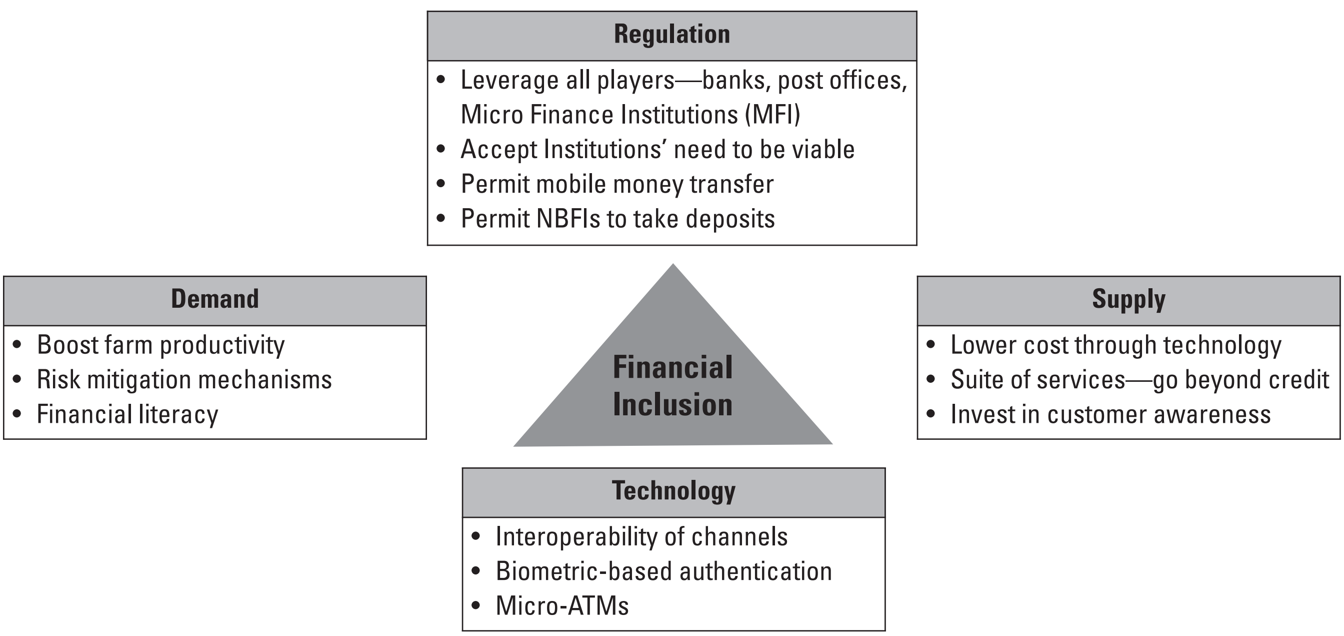
To illustrate the point about costs, the policy still fails to recognise that last mile banking has additional costs and the financial institutions need to be viable. Way back in 1988, ACRC[23] reported that the rates charged by formal financial institutions are ~3% below the viable lending rate. Lower rates also do not provide any gain to the client, if transaction time cost and other associated costs are considered. A recent study shows that while the interest rates of MFIs are high at 25% as compared to 12.7% for the formal sector, the actual cost to the client is higher for the formal sector on account of time taken, documentation and bribery (NCAER, 2011[24]). Occasionally, there are welcome pronouncements that adequate and timely credit is more important than cost of credit but the practise remains focussed on keeping costs unviable. Recent capping of interest rates of microfinance institutions is one such example. Such measures paradoxically have the potential to cause exclusion rather than inclusion as micro lenders in order to be within permissible margin will avoid going to difficult geographies with sparse population.

The net result of this approach has been that while the country has a vast and diverse banking infrastructure and a well spread microfinance model, the challenge of making inclusion meaningful and covering financially excluded population remains a major challenge.

Changing the Policy Paradigm: Achieving Higher Inclusion

India is at a tipping point where enablers such as issue of "Unique Identification Number- Aadhar,[25] innovations in mobile technology and high mobile phone penetration, vernacular based micro-ATM and an efficient microfinance sector have opened a policy window.[26] A few innovative and bold steps by both market players and policy makers are needed to seize this opportunity and change the paradigm from "obligation" to "opportunity."

Meaningful financial inclusion will need concerted action across the four pillars—Demand, Supply, Technology and Regulation (See figure). The required action from the market and government are interlinked and overlap across all pillars other than regulation which is an exclusive policy domain.



The policy memo touches upon two required policy actions which have the potential of substantially enhancing financial inclusion.

Allowing Microfinance Institutions (MFIs) to Accept Member Deposits

Government policy needs to decisively move from channel bias to leveraging the strength of each player whether a post office or MFI. The policy needs to recognise that with nearly 20 million clients, that too in an adverse external environment, the contribution of the microfinance sector needs to be leveraged rather than ignored. Retailing small amounts of loan (~$150) at clients' doorstep, while maintaining costs much below global/regional level (Table 1), the sector has bridged the last mile gap.

Policy Stance toward MFIs Examined

The public policy despite occasional references to the microfinance sector has remained neutral for most part and now borders on hostile. Current policy paradigm has two underlying strands a) MFIs even those which are NBFCs and hence regulated by the Central Bank cannot accept deposits and b) the cost of credit retailed by the MFIs is too high. Both assumptions/prescriptions suffer from ignoring empirical facts and global best practices.

Can Depositor Interest Not Be Protected with MFIs?

On the deposit side, the concern is about depositor interests and systemic risk. The policy concerns in the wake of mushrooming of NBFCs and the crisis in late 1990s have led to tighter regulation and regulation induced reduction in number of deposit taking institutions. In an interconnected financial world, while the regulations have ensured that share of public deposits in NBFCs source of funds dropped to 0.5% during 2010–11, share of other forms of public funds have gone up [bank borrowings –21%, debentures –22%[27]]. What has changed is the nature of risk underlying the fact that smart and effective regulation needs to substitute conservatism. It is nobody's case to risk either depositor interest or systemic stability, but argue as to how both depositor interest and systemic risk can be taken care of in case NBFC-MFIs are allowed to accept deposits.

Central Bank regulations require NBFC-MFIs to maintain minimum capital adequacy (CAR) of 15% and as excess leverage can pose risk, to begin with SI-NBFC-MFIs can be allowed to mobilise deposits from members (not public) in 1:2 ratio of CAR: Deposits. Going forward, the maximum permissible level of deposits can be linked to the rating grade. As another layer of prudential regulation, the deposits with MFIs can be covered under deposit insurance scheme and MFIs be required to maintain minimum liquidity ratio like banks. While the above measures can adequately take care of apprehensions of putting poor people at risk, these will also end the present uni-dimensional relationship between the MFI client by creating a two way interaction where the MFI is also partly dependent on its relationship with clients to generate funds for intermediation. Diversification of liabilities in the form of deposits will also reduce liquidity risk for MFIs. Layered financial infrastructure starting from credit only NGOs, to restricted deposit taking NBFC-MFIs and finally banks will also be in line with examples from other countries with a strong microfinance sector. The Microcredit Regulatory Authority (MRA) in Bangladesh which supervises the operations of NGO-MFIs allows for compulsory, voluntary and term deposits subject to the various conditions like deposits should not exceed 80% of loans outstanding. Deposits now account for 35% of liabilities of NGO-MFIs in Bangladesh. Nepal was the first country in South Asia to introduce specific regulations for the microfinance sector: the Development Banks Act, 1996 and the Financial Intermediary Societies Act (FISA), 1998. The regulation provides for limited banking license- various categories of Microfinance Development Banks and now deposits account for ~47% of liabilities of MDBs.

It is not that poor who do not save with banks in India do not save; they continue to save with local grocery store or a local chit or relatives or under their mattresses. Is it acceptable just because they are outside the purview of the central bank? It is high time this issue is seen from the prism of financial inclusion and development rather than purely as a systemic issue.

The Bogey of Cost

The cost fixation needs to be fixed based on facts and not perceptions. It is well recognised that delivering services at the doorstep has a cost higher than branch based model. Given that, apples need to be compared with apples and on that count, Indian MFIs score above their global peers (Table 1) in Operating Expense Ratio (OER). As the costs are a function of funding cost, operational cost and risk cost any further lowering of cost can only come through reduction in funding cost. Under the present regulations, MFIs depend on equity (~20%) and wholesale loans from banks (~80%) for their funding. If MFIs are allowed to take deposits even in the ratio of 1:2 of CAR: Deposits, it can lower the lending cost by 3.6 % (Table 2).

Table 1. Operating Expenses Ratio (OER) of MFIs

REGION	OER*
India	**10.9**
South Asia	12.8
EAP	14.1
Africa	29.3
LAC	20.2

Source: M-CRIL, 2012

Thus, allowing well regulated NBFC-MFIs to accept deposits can create a win-win position by lowering the costs, allowing for a holistic relationship between MFIs and Clients as well as lowering the liquidity risk of MFIs by not being solely dependent on bank funding. On inclusion side, this can immediately add 20 million clients impacting 100 million (including their household members).

Table 2. Existing Cost Structure Compared with Deposit-based Structure

Existing Cost Structure		Cost Structure with Deposits	
Cost of equity (20%)	0	Cost of equity (20%)	0
Cost of bank loans (80%)	11.2	Cost of bank loans (40%)	5.6
Cost of operations	11	Cost of deposits (40%)	12
Risk cost	1	Cost of operations	11
Total Cost	**23.2**	Risk cost	1
		Total Cost	**19.6**

N.B.: 1. Equity taken as zero cost. 2. Bank loans costed at 14%. 3. All costs as % of portfolio.

Mobile Money Transfer

Besides savings, remittances and micro insurance are much needed services required by the poor. Literature suggests that remittances through mobile phones are not only less costly but also allow customers to transact any time. The high penetration of mobile devices in India (936 million) needs to be leveraged for remittances. World over mobile money transfer has two architectures a) Carrier only model and b) Bank-Carrier partnership model. In India, Reserve Bank of India starting with initial guidelines in 2008 till date has remained focussed on the partnership model. Similar to the underlying approach in not allowing MFIs to accept deposits, reliance on bank-led approach, concerns on systemic risk and money laundering prevail for mobile money transfer. Before going into global examples of carrier only model and its advantages, the impact of existing policy on inclusion agenda needs to be understood. By prohibiting cash out at mobile vendor outlets, the policy precludes anybody without a bank account (65% of population) from making use of this service. Keeping aside the systemic concerns, it is difficult to comprehend the logic behind tying money transfers to bank accounts as it only benefits the included.

Coming to risks, the prudential regulations of non-bank mobile money providers based on international examples like M-Pesa in Kenya as well as outlined by Di Castri (2013[28]) in his paper can effectively mitigate the risk of mobile money customers. The challenges of money laundering can be met through limiting the maximum amount of remittance and linking the mobile accounts to Aaadhar. 300 million Aaadhar numbers have been already issued and it is planned to cover the entire population by March 2013. This opens a critical policy window in mobile money transfer as linking of Aaadhar numbers to bank accounts for direct transfer of government subsidy is already in progress. Perceived risks of money laundering are better met by lowering the rate of financial exclusion and enhancing financial integrity through electronic transactions that can be monitored and traced more easily than cash. The potential of allowing carrier based transfer in speeding up financial inclusion can be gauged from the fact that of the 2.5 billion financially excluded people in the world, 1.7 billion have a mobile phone.

International experience in the form of M-Pesa provides an example of leveraging mobile device. M-Pesa was launched by Safaricom in Kenya in 2007 and now 70% of Kenya's poor and unbanked households have at least one M-Pesa user. The M-Pesa transactions account for 70% of all electronic transactions in the country but account for only 0.2% of value underlying the small value and frequent need of money transfer by the financially excluded and especially the migrant population. The link between higher inclusion and carrier based model is clearly seen in Di Castri (2013, p. 11) paper wherein of the 14 fast growing mobile money deployments, 12 belong to carrier based model. The flipside of M-Pesa's applicability to Indian market is presence of multiple mobile network providers in India as against monopoly of Safaricom in Kenya. Multiple service provider challenge can be met through building systems for interoperability across networks like banks.

The Reserve Bank of India has been gradually easing the norms for mobile money transfer like allowing "mobile wallet" in 2010 allowing up to 5,000 rupees with mobile operators that can be used for merchant transactions. Recently, mobile money transfer riding on India Post infrastructure for cash-in and cash-out has also started. It is hoped that in near future passion for financial inclusion will prevail over financial stability concerns on carrier based model. Global best practices in the form of matching liquidity and other risk mitigants can be adopted to address current concerns (Di Castri, 2013 & Tarazi M. & Breloff P., 2010[29]).

Allowing NBFC-MFIs to accept deposits and allowing carrier based cash transfers have the potential of bringing much needed savings and remittance services to a minimum of 200 million. However, these measures need to be backed by action on the demand side to translate increased financial access to economic growth. Poverty being primarily rural in India, key demand factors such as rain dependent agriculture, low risk appetite of the poor and their inexperience in setting up micro-businesses need to be addressed through public investments in agriculture, availability of risk mitigation mechanisms and provision of support services.

It is hoped that if the above steps are taken, the speed of financial inclusion can be accelerated, inclusion can be made meaningful and people will be able to avail of services they require rather than services offered. The suggested roadmap comes with a caveat that implementing suggested changes in isolation will be counterproductive. For ex. allowing NBFCs to accept deposit without appropriate regulatory oversight can lead to putting depositor's interest at risk. Let a thousand flowers bloom and compete under the facilitating eye of financial regulation and policy as against banking monopoly. Let market and customer loyalty provide answers on effectiveness rather than regulatory conservatism.

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