Financial Inclusion Strategies For Inclusive Growth In India

Sarath Chandran, B.P. and Manju, T.K.

VVM's Shree Damodar College of Commerce and Economics, Goa,
Carmel College for Arts, Science and Commerce for Women, Goa

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1. Introduction

The two decades of post reform period in India demonstrated the transformation of the economy in to one of the fastest growing economies of the world signaling the emergence of the nation in the new geo political and economic order and hence eliciting lot of international attention. But this higher economic growth is confined to some affluent sections and failed to translate in to well being of the large number of deprived and marginalised sections due to various structural rigidities. This is amply exhibited in the marginal improvement in the socio economic indicators of the lower rungs of the population. Even though poverty is declining, the rate of decline is much more desired given the narrow way we define poverty in India. There is also a divide between the 'haves' and 'have not' which result in to large disparities in health and nutritional status, education and skills, as also in availability of clean water and sanitation. This disparity is striking among excluded groups such as SCs, STs, OBCs and some minorities, between gender, rural and urban areas and some backward regions (Planning Commission). In order to address this problem of social exclusion, the 11th plan chartered a strategy of inclusive growth. The approach paper of the plan emphasised that 'the 11th plan provides an opportunity to restructure policies to achieve a new vision of growth that will be much more broad based and inclusive, bringing about a faster reduction in poverty and helping bridge the divides that are currently in focus'. More over economic growth to be sustainable, it requires all sections of the society included and participating in the growth process.

Financial inclusion is one of the methods through which Inclusive Growth can be achieved in India where large sections are unable or incompetent to participate in the Financial System. An inclusive financial system mobilizes more resources for productive purposes leading to higher economic growth, better opportunities and reduction of poverty. On the other hand financial market imperfections, such as information asymmetries and transactions costs adversely affect the poor, the micro- and small enterprises resulting in lack of opportunities, persistent inequality and slower growth. Also financial inclusion is inevitable in creating economic opportunities to the poor, sustaining it, overcome the risk associated with it and continue to participate so that they become successful economic agents to the growth process of the country. Keeping this in mind Government, RBI, banks and other financial institutions are making policy interventions to accommodate the vulnerable in to the financial system. In this backdrop, the paper discusses various strategies for financial inclusion in India in the larger context of inclusive growth in the country.

2. Financial Inclusion – Definition

There are many definitions on Financial Inclusion. Financial inclusion can be defined as a “state in which all people of working age have access to a full suite of quality financial services, provided at affordable prices, in a convenient manner, and with dignity for the clients” (Accion International 2009). The Rangarajan Committee defined financial inclusion as "the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost.” (2008). It includes access to banking services, credit, insurance, savings and assets, money advice and financial literacy and capability. The barriers to financial inclusion are access exclusion, condition exclusion, price exclusion, marketing exclusion and self-exclusion.

An inclusive financial system facilitates efficient allocation of productive resources and thus can potentially reduce the cost of capital. Access to appropriate financial services can significantly improve the day to-day management of finances (bill payment, money transfer etc.). Also inclusion in to financial system protect unbanked people from informal sources of credit, who charge higher interest rates and often resort to unethical/harsh recovery practices. Access to a bank account provides avenues for secure and safe saving practices. A bank account can also provide a passport to wide ranging financial services such as overdraft facilities, debit card and credit cards. A number of financial services, such as insurance and pension, necessarily require access to a bank account. Thus, an inclusive financial system enhances efficiency and welfare of a society.

3. Extent of Financial Inclusion in India

As per NSSO data (2003), 45.9 million farmer households in the country (51.4percent), do not access credit, either from institutional or non-institutional sources. Overall 73 percent of farm households do not have access to formal credit sources. Exclusion is most acute in Central, Eastern and North-Eastern regions - having a concentration of 64% of all financially excluded farmer households in the country. Overall indebtedness to formal sources of finance alone is only 19.66% in these three regions. Marginal farmer households constitute 66% of total farm households. Only 45% of these households are indebted to either formal or non formal sources of finance. Among non-cultivator households nearly 80% do not access credit from any source. Only 36% of ST farmer households are indebted (SCs and Other Backward Classes - OBC - 51%) mostly to informal sources. Analysis of the data provided by RBI through its Basic Statistical Returns reveal that critical exclusion (in terms of credit) is manifest in 256 districts, spread across 17 States and 1 UT, with a credit gap of 95% and above. As per CMIE (March 2006), there are 11.56 crore land holdings and 5.91 crore KCCs have been issued as at the end of

March 2006, which translated into a credit coverage of more than 51% of land holdings by formal sources.

It is pertinent to look some of the financial performance indicators of India in the recent past. The number of rural bank branches increased from 22 percent in 1969 to 41percent in 2007. The population per office in rural areas increased indicating lower financial deepening in rural areas. Out of the 600,000 habitations in the country, only about 30,000 have a commercial bank branch. Coverage of financial services (estimates based on various studies and Market Survey) indicate only 40 percentage of population have Check in accounts, 10 percentage in Life Insurance, 0.6 percentage in Non-Life Insurance, 2 percent in Credit Card and 13 percent in ATM & Debit Card. The geographical coverage of banking shows only 5.2 percent villages are having a bank branch and small farmers which constitute 82.1 percent is largely left out from the formal banking system.

Sarma calculated Index of financial Inclusion in India taking three dimensions such as Banking Penetration (proxied by number of bank A/C per 1000 adult population), Availability of Banking System (proxied by number of bank branches and no. of ATM per 100000 adult population) and Usage of financial system (proxied by the size of bank credit and bank deposits, relative to the GDP). The computed Financial inclusion index for India is 0.194 and belong to Medium Financial Inclusion Countries with banking penetration Index (0.185), availability of banking (0.096) and usage of financial system (0.186).

4. Rationale and Benefits of Financial Inclusion

The need for financial inclusion arises out of multiplicity of reasons. For vast number of remote and inaccessible areas, the physical distance is acting as deterrent to reach the financial institutions and access varied financial services. Compounding this is the demand and supply side constraints affecting the spread of financial services to the marginalized sections of the society. On the demand side the barriers to financial inclusion include lack of awareness, low incomes/assets, social exclusion and illiteracy. The supply side difficulties include distance from branch, branch timings, cumbersome documentation and procedures, unsuitable products, language and staff attitudes. Also the Know your Customer (KYC) norms of the financial institutions provide valuable identity and address proof to the section of population who otherwise looking for some kind of identities. The central problem faced by the excluded population are the lack of access to the formal system, lack of perception about the functioning of the financial system, lack of information about the diverse products and services and lack of selection of the appropriate instrument and services which is most suited for them. The sheer magnitude and size of the excluded population make financial exclusion the barrier to unleashing the "fortune at the bottom of the pyramid."

Financial inclusion presents number of benefits to low income households and small and microenterprises in the country. First and foremost it facilitates economic transactions to the large number of new economic agents. Financial inclusion helps low-income families who have small, unpredictable, and often seasonal incomes to manage their resources well. Families use financial services to gain access to education, health care, and other necessities that improve their quality of life. Low-income families who are subjected to many vulnerabilities can protect against these vulnerabilities through savings, credit, insurance, remittances provide sustainable and low-cost coping strategies. Enterprise owners can use credit or savings to make productivity enhancing investments in productive assets. The right financial infrastructure can help asset recognition of the poor through financial leveraging. Finally financial services foster independence and build economic citizenship by giving people the ability to actively participate in their communities and countries.

Empirical evidence suggests that improved access to finance is not only pro-growth but also pro-poor, reducing income inequality and poverty (Beck, Demirgüç-Kunt, and Honohan 2008, 2009). Cross-country regressions have shown that economies with better-developed financial systems experience faster drops in income inequality and faster reductions in poverty levels. Financial depth can have direct and indirect effects on small firms and poor households (Beck, Demirgüç-Kunt, and Honohan 2008). Greater depth is likely to be associated with greater access for both firms and households, making them better able to take advantage of investment opportunities, smooth their consumption, and insure themselves.

5. Challenges to Financial Inclusion

There are many challenges faced by banks in India on financial inclusion process. Even though there are many villages in the country without bank branches, penetration of bank branches in to rural areas is difficult as they are unviable, saturated and having higher transaction cost. The villages are fragmented limiting the scale of operation of banks in rural areas. This necessitates last mile of financial inclusion to be met with a combination of agents and providers through technology leverage. The present Business Correspondent (BC) model is too restrictive, cash delivery points are too modest and the ideal financial inclusion model is yet to evolve in the country. The robust financial inclusion model requires comprehensive participation of all stakeholders which is currently lacking in the country. Financial inclusion among urban poor warrants an alternate strategy as the physical access is not the critical issue here. The pricing of financial assets and services is delicate in urban areas as it should ensure the poor are able to afford them at these prices. Also urban poor, particularly the slum dwellers suffer from identification problem as they are frequently moving from one part of the city to another or from one city to another. Lack of financial literacy among the urban poor or lack of marketing of financial instruments to the urban poor lead to limited awareness of financial portfolios by these people. Sometimes there is a self exclusion by the poor from the formal system as they are heavily depended on the informal credit sources which cater according to their convenience. Today's complex financial services market offers consumers a vast array of products and service providers to meet their financial needs. This degree of choice requires that consumers be equipped with the knowledge and skills to evaluate the options and identify those that best suit their needs and circumstances. There is urgent need for financial education to make an informed choice from diverse options available to consumers and also refrain from financially destructive transactions. Unfortunately the level of financial literacy is very low in India. In this scenario, the Committee on Financial Inclusion (2008) gave six approaches to tackle the issue of financial inclusion in India. These include credit to the farmer households, bank advice on agriculture related matters, opening branches in villages with large population, simplification of the procedures in relation to granting of loans to small borrowers, further strengthening the SHG-Bank Linkage Programme (BLP), and effective implementation of business facilitator and correspondent model.

6. Financial Innovation Efforts in India

Banks were making many initiatives to improve financial innovation in India. Kisan Credit Card (KCC) Scheme was launched in 1998-99 to provide insurance cover to the farmers. In November 2005, the RBI asked banks to start no frill accounts to bring unbanked people in to the system. As on 31st March 2009, there were 3.3 crore No Frill Accounts opened by banks in India. Also General Purpose Credit Card scheme was started to ensure easier credit facility to the people without surplus. The total number of GCCs issued by banks as on end March, 2009 rose to 0.15

million. KYC Norms were simplified to give easy identification with the banking system. Credit innovations like micro finance credit were introduced to lend credit to large number of needy population. Self Help Group (SHG) Bank linkage programme was developed to provide requisite loan to the SHGs. Banks were started using Information Technology in a large way that are secure, amenable to audit and eventually inter operable. ATM Expansion Scheme was liberalized and Electronic Benefit Transfer (EBT) through Banks was introduced. In order to penetrate in to rural areas schemes like Liberalised Branch Expansion, Business Correspondent (BC) Model, Expansion of Banks in the North-East and Financial Literacy and Credit Counseling were initiated.

7. Financial Inclusion Strategies

Despite the difficulties faced by banks to expand their operations in the rural areas, RBI is seized with the idea of issuing fresh banking licenses to private players with the intension of improving financial inclusion indicators. The idea behind this thinking is that country's credit - GDP ratio is about 50 percent which warrants expansion of banking networks. But this expansion should be directed towards the coverage of unbanked/under banked/excluded sections in rural areas. This is because last round of branch licensing resulted only marginal improvement on rural coverage. Of the 9000 branches of private banks in the country, just 1138 are located in rural areas. Of the loan portfolio of Rs. 513593 crore, lending to rural people constituted just Rs. 7,353 crore at the end of Sep 2009. So when RBI goes for next round of bank licensing, focus should be on rural branches, adequate and timely credit to rural folk, prevention of cartelisation by major banks.

a. Micro Finance Institutions

Based on the success of Grameen Bank in Bangladesh, large number of micro finance institutions emerged in India to provide credit and financial products to marginalized sections of the society. But the character of these micro finance institutions changed over these years. Micro finance has changed from community initiatives where the surplus stays within the group to corporate enterprise. IPOs, CEOs, growth charts are used to attract private funds made them money making institutions out of misery. Micro finance institutions in the garb of rating and financial sustainability charged high interest rates leading the borrowers resorting to suicides. This led to an important question of regulation or no regulation of micro finance institutions. It is generally felt profit oriented money making MFIs should be regulated whereas self sufficient – community based organisations working among the poor need to be encouraged. Banks should facilitate MF products such as Micro savings, Micro Credit, migrant worker remittances with MF and Micro insurance

b. The BC/BF Model

The Business Correspondent/ Business Facilitator (BC/BF) model that the RBI had initiated in 2006 offers a significant opportunity to scale-up and deepen financial access by creating an extensive network of village-level touch points. Business Facilitators are primarily involved in creating awareness, processing and opening accounts where as Business Correspondents in addition mobilise deposits and disburse credits on behalf of the banks. In order to make the BC/BF model effective certain measures are required from the current level of operations. These include, putting in place an extensive network of village-level touch points, providing basic infrastructure, initial finance to cover pre-operative costs, training and building the capacity of BCs for high quality origination, high quality technology for smooth, easy and efficient operations, long-term working capital loans for ensuring sustainability and providing additional credit line for BCs to originate loans.

c. Agent Banking – India Post

Post Offices in India can play an important role in providing banking services to rural areas in view of the low-bank penetration, credit needs of workers, and wide occupational, income and educational variations found in villages. India Post has the largest postal network in the world with 155,000 post offices, 139,000 of which are in rural areas, holds 220 million savings accounts and 11 million insurance policies providing rural outreach that is so vital for financial inclusion. Post offices in India have provided savings since 1882, life insurance since 1884 and money remittance schemes, thus involved in financial inclusion process long back. The Expert Committee appointed by the Government on 'Harnessing the India Post Network for Financial Inclusion' suggested some major steps in this direction. These include delivery of lightweight, low cost bank accounts by post offices to all Indian citizens and especially to the financially excluded population. India Post should look for ways to leverage its low cost platform by providing India Post branded accounts to other strategic partners, such as MFIs, mutual fund and insurance companies, and telecom operators.

d. Mobile Banking

In India, mobile banking is considered the next big step in banking expansion particularly in the rural sector. Mobile banking provides a banking interface at low transaction cost using technology. Cost of an ATM transaction is five times that of a M-banking transactions and transaction at a bank branch is almost 15 times more expensive. Kenya was the first country to use money transfer through mobile phones known as 'M-Pesa' and there are around 7 million users in a country of 39 million people. Banks can tap financial inclusion effectively through M-banking as mobile penetration is increasing in rural areas. For the rapid expansion of mobile banking in the country a pro-active participation of big technology players and communication companies with the banking system is important. Today there are over 470 million mobile phone users versus less than 200 million bank account holders. It is expected mobile banking usage in India to grow at 52 percent to over 53 million in 2013. Banking license to a joint venture between one phone company and an existing commercial bank with a specific mandate for inclusive banking can speed up the spread of mobile banking in the country. In India transaction security is a major concern since hacking is also moved on to the mobile platform. Regulators, Banks, telecom service providers and handset manufacturers should come together to find a solution so that apprehensions are removed and wide use of it possible in near future.

8. Conclusion

Banking on the poor is a viable option in India as there are huge mass at the bottom of the pyramid. There are enormous unmet potential lying in the rural areas for financial institutions. If financial institutions could successfully tap this potential there would be a 'win-win' situation for institutions and people. Use of technology plays an important role in leveraging banking services to rural areas as it lower the cost of maintaining the account. Mobile banking is the most viable option for financial inclusion as it involves less transaction cost. Further bank licensing should be directed towards covering the rural areas. Also there should be convergence between regulator, banks, telecom companies, software companies and handset makers for electronic transfer of cash. Financial literacy and credit counseling programmes can create critical mass for financial services which make financial inclusion viable. Financial inclusion by introducing electronic payment system is one of the solutions to reach the masses in India. The existing Indian Post Offices with large rural outreach is best suited for taking financial inclusion process swiftly. Financial literacy about various bank portfolios, Unique Identification Authority of India

(UIDAI) for easy identification, National Payment Corporation of India (NPCI) and Micro ATMs are some of the important tools of financial inclusion in India.

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