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FINANCIAL EXCLUSION: A THEORETICAL APPROACH

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1. Introduction

The problem of financial exclusion has gained wide currency in recent times owing to the aggressive persuasion of financial sector reforms in India, downsizing government share in nationalized banks, liberalizing the bank licensing policy and allowing the entry of foreign banks. The unfettered competition injected in to the financial sector with liberal agenda has in fact spawned a number of sea changes in the financial scenario. The vigorous pursuit of profit in place of the objective of "social and development banking" has paved the way for a shift from "mass banking" to "class banking" resulting in the exclusion of a segment of population from the mainstream financial framework, who are regarded as "credit unworthy" in financial parlance. The ICT enabled banking services have also kept some people away from the financial services, leading to the technical exclusion of these people. Financial exclusion is not a new phenomenon, although its dimensions have been changed in tune with the policy and technology related changes in recent times. This paper intends to focus on financial exclusion with a theoretical perspective.

This paper is structured as follows. The following second section is set aside to give an account of the definitions of financial exclusion. Third section sheds light on the prominent theories of financial exclusion. The fourth section elaborates on the strategies to address the problem of financial exclusion. Final section offers conclusion.

2. Defining Financial Exclusion

Defining financial exclusion is a very complex task as many academicians, practical researchers and financial analysts have attempted to define it in divergent ways. Notwithstanding the minute differences across various definitions, once could conveniently categorize these definitions under two broad heads: One, based on banking experts' perceptions of defining financial exclusion associated primarily with their commitment to fulfil the target of attaining cent percent financial inclusion as directed by the RBI, and the other based on how financial economists define it in a way as to connect the issue of financial exclusion with other broad fundamental issues like social and economic exclusion. Obviously, the former category of definitions conveys a very narrow but practically relevant meaning of financial exclusion whilst the latter defines it from the perspective of a theoretical background encompassing all dimensions of financial exclusion and its intertwining with other core areas like social and economic exclusion. Needless to say that of the two categories of definitions, the latter serves the purpose of a fundamental researcher in a better way. Nevertheless, a detailed account of the all definitions of financial exclusion is worthwhile as it helps one to comprehend the broad meaning of this phenomenon.

If one attempts to trace out the origin of the term financial exclusion, it can be seen that this term first came into the financial literature in 1993 to describe a situation of limited physical access to banking services on account of the bank closures . It means that in its original form

financial exclusion meant not the lack of access to financial products like banking and insurance products and the like which ameliorate the vulnerability of the people but merely the lack of geographical access to banks. But it was in 1999 the term financial exclusion began to be used to designate the condition of not having access to mainstream financial services (Kempson and Whyley, 1999).

Unsurprisingly, financial exclusion appears to have been associated with social and economic exclusion. Some definitions of financial exclusion encompass this association in a meaningful manner. We now attempt to have a bird's eye view of such definitions. First of all financial inclusion (or, alternatively, financial exclusion) has been defined in the context of the larger issue of social inclusion (or exclusion). One of the oldest definitions by Leyshon and Thrift (1995) defines financial exclusion as referring to those processes that serve to prevent certain social groups and individuals from gaining access to the financial system. According to Sinclair (2001), financial exclusion means the inability to access necessary financial services in an appropriate form. In a speech in 2006, RBI deputy governor Rakesh Mohan said, "financial exclusion signifies the lack of access by certain segments of the society to appropriate, low cost, fair and safe financial products and services from mainstream providers". Usha Thorat (deputy governor, RBI) expressed similar views in a speech in 2007, as "by financial exclusion we mean the provision of affordable financial services, (viz., access to payments and remittance facilities, savings loans and insurance services) by the formal financial system to those who tend to be excluded".

3. Theories of Financial Exclusion

It appears that financial exclusion is more associated with the broader form of exclusionary processes like economic and social exclusion. Hence, providing a theoretical framework to financial exclusion will have to take into account the fundamental and institutional variables, which have been at work in a country, manifesting itself into the concerns of economic and social exclusion. In countries plagued by fundamental economic and social disequilibria, the genesis of financial exclusion could be traced to factors causing such disequilibria viz. the prevalence of a multiple form of social stigma, religious fundamentalism, retrogressive social mind set up, existence of administrative bottlenecks, poor execution of state sponsored welfare schemes, terrain geographical setting and economic inequality brought about by the failures of pro-government initiatives like land reforms. These factors partially describe the reasons of financial exclusion as it evolves today whereas they may well explain why financial exclusion existed in days prior to the implementation of pro-liberal financial policies across the world particularly in India. Earlier literature on financial exclusion exhibits the fact that people at large were excluded from accessing basic mainstream financial products in India primarily on account of the lack of branch expansion in rural areas and private ownership of majority of banks. With banks having achieved considerable progress in branch expansion thanks to the nationalization of banks in 1969, geographical dimension to the problem of financial exclusion almost ceases to exist except in some uninhibited or marginally inhibited places, emphasis has now been shifted to other dimension of exclusion like, access especially conditional access, technological access etc. Competition among the banks unleashed by the aggressive financial sector liberalization policies since 1991 has forced banks particularly the nationalized banks to shift their priority from the "social and development banking" to "profit oriented banking". This has had undoubtedly wide-ranging ramifications in the realm of social and economic life of the country.

The entire issue of financial exclusion needs to be looked into from this perception and practical change in the nature and functioning of the financial sector.

Here, we try to unearth the theoretical framework, which can illustrate the kind of financial exclusion that happens due to factors purely economic in nature. It must be born in mind that while today's financial exclusion is more attributed to factors associated with technology, financial crisis and market driven motives, the fundamental causes viz. lack of income, assets etc need to be stressed.

We have two theories to explain the process of financial exclusion.

1. Free Market Model.
2. The Theory of Asymmetric Information.

Free Market Model

We technically label this model as the "Share holder Wealth Maximization Model, hereafter abbreviated as SWMM or simply as the Free Market Model. Needless to say, that the true free market model has a long history and the usefulness of such a model to sort out many fundamental economic problems has been well documented and still debated. There are different variants of such model. But, the variant, which we rely on here for our analysis, is the one dealing with financial market.

A good chunk of economic theories starting from the time of Adam Smith has immensely contributed to the development of projecting "Market" as the sole panacea for all illness of an economy. In its sum and substance, these theories argue that a deregulated economy has an inherent tendency to move closer to "Pareto Optimum" where, technically speaking, all resources are well spread out and employed in a manner, which ensures maximum possible wealth creation. As encrypted in the concept "Pareto Optimum", such a condition does not envisage an economic agent's position being deteriorated following the enhancement of the gain of other persons. Starting from the time of Classical writers as Adam Smith and David Ricardo it has been claimed that competition unleashed by the policy of "laissez faire", will shower the benefits of rooting out all ills that an economy is likely to confront with. Intervention by the policies of government will take away the economies from the path of attaining growth accompanied by the removal of all type of imbalances. The free market model as we explain here has been built on this philosophical foundation.

Unlike in the past, now financial institutions indulge in stock market operations to collect fund for their fundamental functions. Most of the leading financial institutions encompassing banking institutions have embarked on placing their shares in the capital market with much advertisement. Besides the new generation private banks thronging on the capital market to collect fund, nationalized commercial banks in India have also followed the suit, thanks to the policy change of government in favour of disinvestment policies. As a testimony to this, one can notice the recent announcement by the Finance Ministry that it has decided to offload 49% of the government stake in the State Bank of India. Fallout of this sweeping change in the financial basis of these institutions has been a tendency to show that they are rated high by the internationally reputed rating agencies like Standard and Poores. Thus, the pressure of making

the Financial Institution worth of stock market investing has in fact forced these institutions to abstain from risky lending.

At this juncture one could find a paradox that whilst deregulation, as the proponents of market driven strategies opine, appears to increase financial inclusion, the opposite, financial exclusion, seems to have surfaced as a growing problem. The argument that deregulation should have resulted in financial inclusion rather than financial exclusion rests on the principle that market driven strategies always lead to the spawning of suitable financial products in response to the market demand. But the problem is that as more financial products are brought into the market, the risk in lending also increases which forces the banks to focus more on certain groups, rather than on customers in general, leading to the financial exclusion of a majority of 'Non-Valuable Customer groups and more strategic inclusion of 'valuable' customer groups. Banks generally believe that inclusion of more 'valuable customer group' even at the cost of the exclusion of the underprivileged or the least 'valuable' will immensely enrich the "value-added' in SWM sense. Most of the new generation banks and private banks seem to have been adopting this strategy. For instance, certain new generation private banks in India do open savings accounts provided that there is minimum cash balance of Rs.5,000/-. This stipulation in fact testimonies the fact that 'valuable customers' are sought after compared to those who wish to open an account with a nil or frill balance. As Boyce (2000, p.649) rightly opines: 'Customer valuation is shown to have become a means to increase shareholder income and wealth, almost inevitable at the cost of further marginalizing the poor and disadvantaged'.

The deregulation of the financial sector in force in India since the onset of the neo-liberal policies has in fact exacerbated financial exclusion. Coupled with this deregulation, the financial crisis, which has become the order of the day, attenuates the financial exclusion process. It has been observed that whenever there is a financial crisis, there is an aftermath of some kind of 'flight to quality' and an emphasis on risk reduction by the financial industry. The result of this herd behaviour of becoming more conscious of financial operation is the 'abandonment and retreat to a more affluent client base'. This also applies to particular geographic localities. This is called the 'financial desertification' process. Leyshon and Thrift (1995, p.312) explains this economic process as 'increasingly exclusionary in response to a financial crisis founded in higher levels of competition and extreme levels of indebtedness'. Evidences show that in many financial systems, financial exclusion has its roots in the changing macroeconomic structural circumstances. Thus, it is evident that financial exclusion is the result of the enhanced competition triggered by globalization and deregulation. Leyshon and Thrift however have argued that not all banks have joined this folk in responding to the neo-liberal call of globalization and deregulation. This argument appears to be correct in Indian context as well especially in the case of those banks in which the government of India has the highest stake and say. Unarguably this shift that these banking institutions have made to 'valuable customers' in the pursuit of enhancing their 'value addition' can right be called as a "strategic shift" which has been underway in banking operations world over. This strategic shift has in fact led to a separation between lower income customers and higher income customers mainly in the case of financial products to which they have access. This separation has been intensified by a lot of other factors including technological advancement that the world in general and banks in particular have gained in recent times, whereas these 'advancements' appear to be not accessible to a large number of lower customers. Equipped with this technical advancement, the higher

income customers have moved themselves to the level of 'global financial citizens' who possess instantaneous access to financial information, transactions and value transfers of their wealth. This emergent status of 'global financial citizenship' apparently has rendered these groups with a new kind of higher v/s the lower income customers. Consequently, as a source of 'value additivity' this former group has become a target of banks especially new generation private and foreign banks in the context of Indian financial system. The overemphasis being laid on this group on account of the above reasons has led either to the intensification of the already existing financial exclusion or to the emergence of the financial exclusion of the 'un-banked' or 'marginally banked' groups. They appear to have apparently less information about the products being launched by the banks, and they are not so heavily targeted for new products innovated by the banks. In short, the market dynamics of the banks appear to have exacerbated the polarization between the low-income customers and high-income customers. In short the above description provides us an understanding of how competition, deregulation and finally the financial crisis brought about by the globalization accelerate the process of financial exclusion. Now we turn to the other two drivers which prompt financial institutions to move after valuable customers and exclude low income and socially disadvantaged customers from accessing financial products. These two drivers viz. securitization and retail disintermediation, which require our immediate attention, are outlined below.

To put in simple parlance, Securitization means corporate relying on the capital market for fund rather than the financial institutions. In other words Securitization is the shifting of credit intermediation primarily by the corporate sector out of the banking system into capital markets. In this sense this is a disintermediation process which makes the financial intermediaries like banks irrelevant. Retail disintermediation on the other hand describes the shift of savings out of the banking system into money-market mutual funds and offshore vehicles. That means people do not save money with financial institutions like banks, rather they invest in capital markets seeking more returns. This process restricts the investment capacity of the banking system. On the other hand, securitization reduces the corresponding demand for commercial bank lending. Thus from both sides, the securitization and disintermediation together, the financial industry has been squeezed to an extent which drives it to resort to banking practices contrary to what they have been supposed to do. These trends have led to the development of investment banking in countries like USA. Thus, banks have responded to securitization and financial disintermediation by re-examining their core banking business. They have started seeking new ways to 'lock in' their customers and make more profit through a process -value addition in SWM language. The following are the main strategic shifts in response to this:

- Innovation of new varieties of deposit instruments.
- Improving risk management and risk mitigation techniques.
- ABS or Asset-Backed Securities techniques in lending.
- Moving into new areas of lending.

All these development viz. competition, deregulation, securitization and disintermediation have prompted banks to follow a kind of 'standardization' in their functioning. The development and the spread of ICT enabled technology revolution have also added fuel to this 'standardization process. Financial institutions like banks and even the corporate banks have started using software to assess credit risks, loan selection and the pricing of financial products. The

application of computer based technology has naturally forced banks to reduce their staffing and the old brick mortar banking has become a thing of the past in many countries. All these are in the search for greater cost efficiency in the operation of the financial institutions. Having developed an array of different financial products, banks can now easily target standardized customers for cross selling its new products. Low-income profile customers may not be capable of purchasing multiple products that the banks are ready to offer. In US market, for instance, banks have been directed towards searching for profitable 'standardized' customers mainly because of the fact they appear to be less risky while being capable of buying multiple products simultaneously.

In the era of unfettered tough competition that the banks have become subject to, many small banks find it easy to be merged with big ones believing in the saying "too big to fail". Merging is often the fastest way to achieve the desired result and helps to explain the US bank merging tendencies. It can be rightly remarked that 'Mergers and acquisitions are central to the dynamic of the standardized customer'. (Dymski and Li (2002, p.5). The pre-regulation banking is characterized by relatively low fixed costs and high marginal cost of servicing customers. But on the other hand, the post-deregulation phase, the phase of new mega banking, is an era of high fixed cost (of establishing ATMs, Creating software, Debit and Credit Cards, product design, testing and marketing) and low marginal costs of servicing customers (because of staff cutting). High fixed costs when spread over a long period does not pose any threat to the bank whereas low marginal cost becomes beneficial. The net effect is a lower cost of customer servicing in the long period. Therefore, the target of banks is to pursue the more profitable customer groups, develop these customer relationships through time and to target them for a wider range of products. Many new generation banks today look like the front room of a five star hotel or a big house. A few cushion chairs replace uneasy and arrogant chairs of the old time. The message is that these banks do not expect many more worthless customers. They want only a few valuable customers. The economic impact of the above process is very visible. That is the mainstream commercial banks increasingly 'desert' the less profitable household groups. If these groups are concentrated in a particular locality, the resultant financial exclusion has an inevitable geographic spatial dimension as well as social and economic. This kind of 'financial desertification' may constrain continued economic and financial development activities.

To put it in a nutshell, the 'Free Market Model" postulates that unchecked deregulation of the financial activities driven by the motive of profit and market signals has a clear message that if uncontrolled it may exacerbate the problem of financial exclusion further, leading to a catastrophe in the financial space of an economy. Two things can happen if the financial sector continues to be deregulated as it is today: One is, at the very least a deregulated financial system can increase the polarization between the financially included and excluded in the societal groups. The other is, at the worst the free market model may also increase the number of groups excluded as risk-based pricing becomes more sophisticated. Therefore, some kind of 'intervention' cum 'partnership approach' to financial exclusion is the need of the hour. In this context, 'intervention' connotes those directions that the government would require banks to do. These actions include government as a mediator to 'self regulation' by the financial industry itself. 'Self regulation' here covers those banking sectors whose primary mission is to develop their regions, and help the poorer sections of the customer-base. Institutions pursing this way

have also scripted successful stories of more profit and greater efficiency in their financial operations.

The Theory of Asymmetric information

Now we start with a word on the crucial distinction that theoretically exists between the transaction in the goods market and transaction in the credit market, which would be worthwhile to comprehend how information asymmetry engenders and exacerbates the problem of financial exclusion. In the goods market the task and objectives of transaction are simpler and comparatively less cumbersome. In such a market, the seller of a commodity "does not worry about who the buyer is and what happens to the commodity after the sale as long as he gets paid" (Gilberto.M.Llanto, 1989). On the other hand, transaction or exchange in the credit market is much more complicated and cumbersome primarily because of the fact that most of the transactions are future contracts in nature. Hence, the relationship built upon a transaction lasts for a long period. For instance, the case of fixed deposit, a home loan, or a personal loan. It is obvious, hence, that in the case of the transaction of these products a great deal of information on the personal characteristics of the borrower is required. In this background, it is quite natural that banks spend a good part of the time in locating a "good" borrower and a "good" project. Unlike the commodity seller who does not worry about the buyer of the financial product, the bank also worries about what the borrower will do with the loan and whether he will abide by the terms and conditions of the contract (Clemenz, 1986).

Generally, it is observed that the banks lend money without complete certainty of whether or not the loan will become a non-performing asset. Since the borrowers know themselves better than the bank, they can gain from understating personal as well as the project's weaknesses and exaggerating positive qualities. If the borrowers do so then we can safely say that the information transfer is hampered by "moral hazards and incentive problems". To address this issue, the banks employ screening techniques to insulate themselves from default risk. This drives banks to exclude somebody from having access to banks. In short, the asymmetric information denies the borrower effective access to financial resources.

4. Strategies to address the problem of Financial Exclusion

Now it would be pertinent to look into various strategies that have been suggested to address the problem of exclusion in general and financial exclusion in particular. First, we shall have a peep into the three financial development theories, which establish the relation between the development of the financial system and the economic development.

The Theory of Active Financial Development or Supply Leading Financial Development:

Placing significance on the setting up of financial institutions as a tool for spreading the habit of engaging in financial dealings among the people, this theory articulates that financial development precedes economic development. Equipping the people with all apparatus of financial instruments is the key to tackle the problem of financial exclusion. Once adequate financial needs of people are legitimately met by the financial system, then the people will start building upon that, necessary other economic entitlements and this economic empowerment of the people will in course reinforce financial development. The wide scale branch expansion of major commercial banks in India since 1969, that is after they were nationalized, was in line with the preposition of this theory. Most of the financial inclusion strategies being envisaged and

implemented by the leading commercial banks in India under the direction of Reserve Bank of India are based on the spirit of this theory. Opening up of No-Frill Accounts is an attempt to offer financial products to the hither to unbanked people with a view to attract them to the world of finance. The figure 1 illustrates the theory of Active Financial Development.

The Theory of Passive Financial Development or Demand Following Financial Development:
Contrary to the argument of the theory of active financial development, this theory states that economic development and economic empowerment of people paves the way for financial development. It is argued that when the people are actively involved in economic activities generating employment and income, the demand for various kinds of financial products tailor made to their needs arises. This generation of demand for financial products will act as stimuli for the establishment of financial institutions. This is because of this stress on demand that this approach has come to be alternatively known as the Demand Following Financial Development. It is generally held that this kind of financial inclusion brought about by this path of financial development will be sustainable in nature compared to the Supply Leading Financial Development. The mushroom growth of informal financial entities in the rural areas of our country can be cited as a best example of how the need forces the people to go in for credit at any price from whatever sources available to them. The entire argument contained in this approach can be illustrated with the help of the figure 2.

The Theory of Intertwining Financial Development:
This theory different from other two theories narrated earlier argues that it is wrong to say that either financial development or economic development precedes each other. The theory articulates that sometimes financial development may lead to economic development and vice versa. Hence, it is difficult to point out where the process ends or starts. It can happen in both ways. The figure 3 captures the entire argument of this approach without any ambiguity.

Having gone through three main theories illustrating the relationship between financial development and economic development and thereby portraying the ways to address the problem of financial exclusion, now we turn towards other two theories, which are predominant in the realm of sociology in the analysis of the process of social exclusion. The increasing popularity of the concept of social exclusion among the sociologist especially since 1990s led to attempts to identify the multi-difficulties faced by the socially disadvantaged groups, and also to suggest measures to help the socially disadvantaged to overcome the multi-difficulties. Differences surfaced among the sociologists regarding the nature of solutions to be adopted to attain social inclusion. These differences entered around two views viz. whether to follow the pro-market policies or state led policies to tackle the problem of social exclusion. These divergent views led to two widely quoted discourse of social exclusion: The Social Integrationist Approach and the Redistributive Approach (Levitas, 1998). These approaches bear relevance to the problem of financial exclusion as well. Below, we attempt to relate these approaches to the problem of financial exclusion.

The Integrationist Approach to Financial Inclusion:
The crux of this approach hovers around the whole dynamics of the Labour Market. This approach suggests that to wipe out the presence of financial exclusion we must provide the

people with the opportunities to participate in the paid work in the labour market. Interestingly, this approach defines the concept of social exclusion in a different fashion that exclusion is nothing but exclusion from the paid work in the job market and hence it prescribes integration through paid work as the better panacea to solve the problem of exclusion. For instance, this approach endeavours to address the problem of the exclusion of the disabled from the labour market through the process of equipping them different with distinct skills, which are seemed suitable to enable them to enter into the labour market. To clean the education system, this approach argues that the system of education must be linked to the needs of the job market. In short, the social integrationists discourse supports a well-integrated society through paid work and relies heavily on the private market to find a lasting solution to the problem of financial exclusion. This approach in that sense appears to be friendlier with the notions of capitalism. It is known that workers do not produce all that they need. Instead, they exchange their labour power in the labour market for other products, which they could buy via the medium of money they are supposed to get from the labour market against the labour power they sell. Here money, in broader sense finance, plays a vital role in connecting the labour market with the product market, increasing the size of the product market and facilitating capital accumulation.

Integration with the labour market can be a best way to tackle the problem of financial exclusion as well. This is because once people are engaged in paid jobs in the labour market, the income generating from such paid works will definitely force them to demand various financial products and thereby leading to their effective financial inclusion. The Mahatma Gandhi National Rural Employment Guarantee Programme (MGNREP), which has been successfully implemented in India, is a fitting example of how integration with the labour market can be a weapon for financial inclusion. Under this programme, every beneficiary that is the labourer will have to open an account with any nationalized bank for getting his or her wages regularly. The wage is disbursed through accounts. Here, so long as a person continues to work under the above said programme, he will have to be in constant touch with the banks, which will cultivate banking habit in that person.

Notwithstanding the bright side of this approach, critics argue that it has too many drawbacks viz. obscuring the inequality between the paid workers; overlooking the gender inequality in the labour market and ignoring the values of unpaid works such as taking care of the children in the family etc. (Levitas, 1998). Critics question the suitability of the labour market in generating employment for the people with learning difficulties.

The Redistributive Approach to Financial Inclusion:
Quite different from the earlier approach, this one argues that the product and labour market are prone to creating inequality leading to the exclusion of those who cannot fall in line with the parameters of market. This approach is built on the premise that lack of an endowment to participate in the customary life of society is the cause that creates exclusion. The creation of a just society rerouting the movement of resources from the “abundant” hands to the “scarce” hands appears to be the solution to tackle exclusion, and hence active interventionist policies through the arms of tax reforms, expansion of benefit systems, reduction of earning differentials, financial recognition of unpaid works, introduction of minimum wages and minimum income for those who are unable to participate in the job market are called for to address the problem of

exclusion. (Chau and Yu, 2002). This view associated with equitable society challenges the problems of inequality created by the product and labour market.

In addressing the problem of financial exclusion, the application of the elements of this approach could be found in many endeavours being adopted by the government. For instance, very often, having been misled by the fact that it is the price barrier, which prevents the disadvantaged in accessing credit from the formal credit market, nationalized banks in India adopt the practice of offering loans at subsidized rate of the interest to the low-income people, agriculturists and petty traders, SCs and STs. This subsidization of loan falls in line with the redistributionist discourse.

The difference between these two approaches lies in the division of responsibilities between the government and the market (labour market) in handling the problem of social exclusion. Both approaches recognize the difficulty that the disadvantaged group may face in the run up to be integrated into the mainstream of the society. The redistributionists argue that the market cannot create jobs for them as the market stands for those who are fit to work. Hence, they request the government to help them achieve a decent standard of living independent of the job market. The integrationists, on the other hand, question the government's ability to provide training to improve the employability of these people.

5. Conclusion

In short the problem of financial exclusion has to be tackled keeping in mind all the fundamental reasons that create and exacerbate the problem in various forms. The peripheral and eye washing strategies that have been implemented by the banks in India under the compulsion of government and RBI will not yield sustainable results unless and until fundamental problems are addressed.

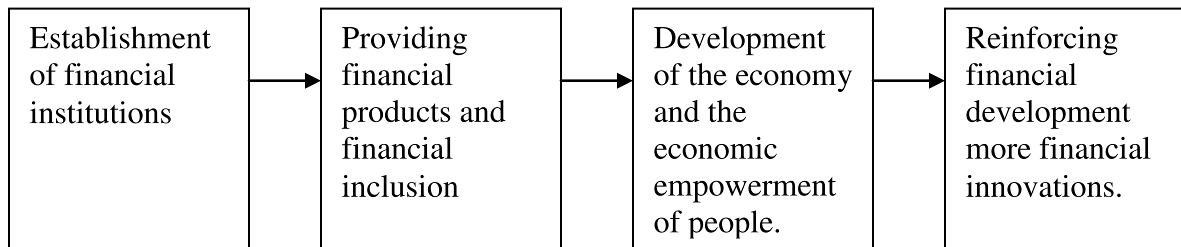

Figure: 1

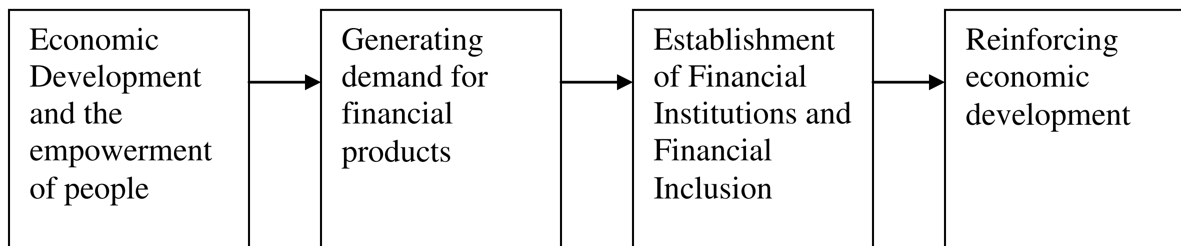

Figure: 2

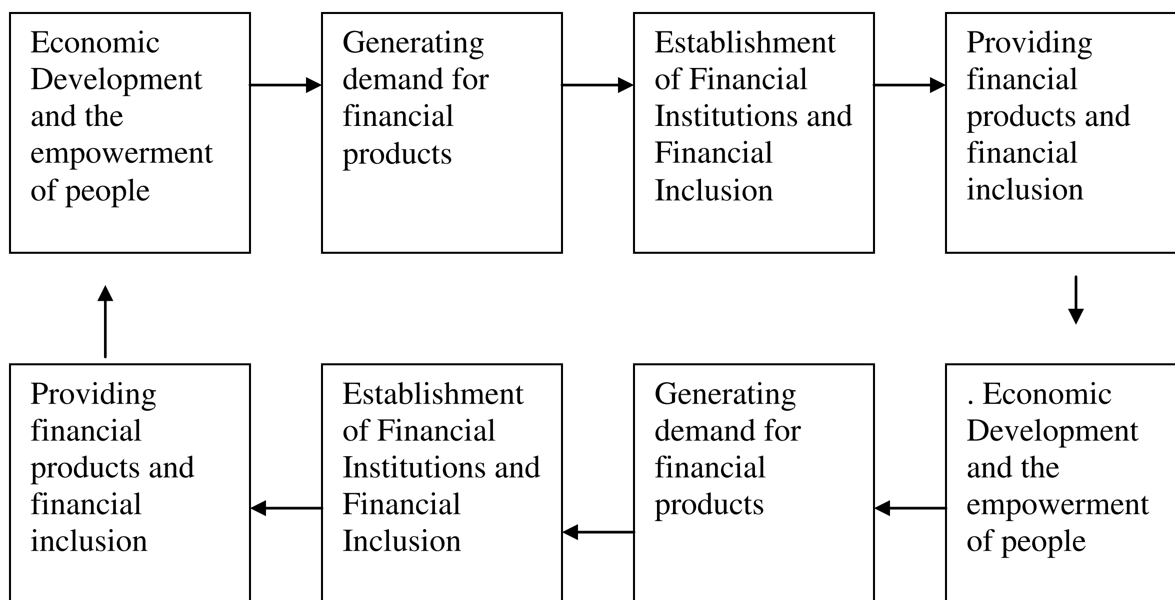

Figure: 3

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