Challenges for India in moving towards Financial Inclusion

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ABSTRACT

The term financial inclusion in banking is the delivery of services at an affordable cost to the majority sections of low-income group. Uninhibited access to public goods and services is the main thing of an open and efficient society. As banking services are in the nature of public good, it is essential that availability of banking and payment services to the entire population without discrimination is the prime objective of the public policy. In India, banking industry has shown tremendous growth in volume and complexity during the last few decades. Despite making significant improvements in all the areas relating to financial viability, profitability and competitiveness, there are concerns that banks have not been able to reach and bring vast segment of the population, especially the underprivileged sections of the society, into the fold of basic banking services. Internationally also efforts are being made to study the causes of financial exclusion and design strategies to ensure financial inclusion of the poor and disadvantaged. The reasons may vary from country to country and so also the strategy but all out efforts are needed as financial inclusion can truly lift the standard of life of the poor and the disadvantaged. In the Mid Term Review of the Policy (2005-06), RBI exhorted the banks, with a view to achieving greater financial inclusion, to make available a basic banking 'no frills' account either with 'NIL' or very minimum balances as well as charges that would make such accounts accessible to vast sections of the population. The nature and number of transactions in such accounts would be restricted and made known to customers in advance in a transparent manner. All banks are urged to give wide publicity to the facility of such 'no frills' account, so as to ensure greater financial inclusion.

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Introduction

The term financial inclusion means the delivery of services at an affordable cost to the majority sections of low-income group. Open access to public goods and services is the main thing of an open and efficient society. As banking services are in the nature of public good, it is essential that availability of banking and payment services to the entire population without discrimination is the prime objective of the public policy. In India, banking industry has shown remarkable growth in volume and complexity during the last few decades. In spite of making significant improvements in all the areas relating to financial viability, profitability and competitiveness, there are concerns that banks have not been able to reach and bring vast segment of the population, especially the underprivileged sections of the society into the fold of basic banking services. Internationally also efforts are being made to study the causes of financial exclusion and design strategies to ensure financial inclusion of the poor and disadvantaged. The reasons may vary from country to country and so also the strategy but all out efforts are needed as financial inclusion can truly lift the standard of life of the poor and the disadvantaged.

When bankers do not give the desired attention to certain areas, the regulators have to step in to remedy the situation. Therefore, Reserve Bank of India places a lot of emphasis on financial inclusion. With a view to enhancing the financial inclusion, as a proactive measure, the RBI in its Annual Policy Statement of the year 2005-2006, while recognizing the concerns in regard to the banking practices that tend to exclude rather than attract vast sections of population, urged banks to review their existing practices to align them with the objective of financial inclusion.

No-Frills' Account

A no-frills account is a bank account that can be opened and maintained with a zero balance, levies zero or nominal charges and does away with the unnecessary services or frills. The downside of such an account is that most of the facilities offered are limited. Once this limit is exceeded, the bank charges for these services. A no-frills account is a real zero balance account in that there is no need to keep any minimum balance in the account and non-maintenance charges are not levied.

Zero balance accounts, on the other hand, do allow you to open the account without any minimum balance, but you may need to subsequently fulfill the minimum balance requirements of the bank or you are charged non-maintenance penalties.

In the Mid Term Review of the Policy (2005-06), RBI encourages the banks, with a view to achieving greater financial inclusion, to make available a basic banking 'no frills' account either with 'NIL' or very minimum balances as well as charges that would make such accounts accessible to vast sections of the population. The nature and number of transactions in such accounts would be restricted and made known to customers in advance in a transparent manner. All banks are urged to give wide publicity to the facility of such 'no frills' account, so as to ensure greater financial inclusion.

'Know Your Customer (KYC)' Norms

Banks are required to provide a choice of a 'no frills account' where the minimum balance is nil or very small but having restrictions on number of withdrawals, etc., to facilitate easy access to bank accounts. Further, in order to ensure that persons belonging to low income group both in urban and rural areas do not face difficulty in opening the bank accounts due to the procedural hassles, the 'KYC' procedure for opening accounts for those persons who intend to keep balances not exceeding rupees fifty thousand (Rs. 50,000/-) in all their accounts taken together and the total credit in all the accounts taken together is not expected to exceed rupees one lakh (Rs. 1,00,000/-) in a year has been simplified to enable those belonging to low income groups without documents of identity and proof of residence to open banks accounts. In such cases banks can take introduction from an account holder on whom full KYC procedure has been completed and has had satisfactory transactions with the bank for at least six months. Photograph of the customer who proposes to open the account and his address need to be certified by the introducer.

Reasonable bank charges

In order to ensure fair practices in banking services, the RBI has issued instructions to banks making it obligatory for them to display and continue to keep updated, in their offices/branches as also in their website, the details of various services charges in a format prescribed by it. In many banks, the requirement of minimum balance and charges levied, although accompanied by a number of free facilities, discourage a large section of population from opening/maintaining bank accounts. With a view to achieving greater financial inclusion, all banks need to make available a basic banking 'no frills' account either with 'nil' or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. The nature and number of transactions in such accounts could be restricted, but made known to the customer in advance in a transparent manner. All banks are urged to give wide publicity to the facility of such a 'no-frills' account so as to ensure greater financial inclusion.

Financial inclusion in India

The Indian economy is growing at a steady rate of 8.5 % to 9% in the last five years or so. Most of the growth is from industry and services sector.

Agriculture is growing at a little over 2 %. The potential for growth in the primary and SME sector is enormous. Limited access to affordable financial services such as savings, loan, remittance and insurance services by the vast majority of the population in the rural areas and unorganized sector is believed to be acting as a constraint to the growth impetus in these sectors. The approach to FI in developing countries such as India is different from the developed countries. In the latter, the focus is on the relatively small share of population not having access to banks or the formal payments system whereas in India, we are looking at the majority who are excluded. FI can be thought of in two ways. One is exclusion from the payments system –i.e. not having access to a bank account. The second type of exclusion is from formal credit markets, requiring the excluded to approach informal and exploitative markets. After nationalization of major banks in India in 1969, there was a significant expansion of branch network to unbanked areas and stepping up of lending to agriculture, small industry and business. More recently, the focus is on establishing the basic right of every person to have access to affordable basic banking services.

Measures of financial exclusion

Financial Inclusion is measured by the percentage of adult population having bank accounts. Going by the available data on the number of savings bank accounts and assuming that one person has only one account, (which assumption may not be correct as many persons could have more than one bank account) we find that on an all India basis 59 per cent of adult population in the country have bank accounts – in other words 41 per cent of the population is unbanked. In rural areas the coverage is 39 per cent against 60 per cent in urban areas. The unbanked population is higher in the North Eastern and Eastern regions.

The extent of exclusion from credit markets is much more, as number of loan accounts constituted only 14 per cent of adult population. In rural areas, the coverage is 9.5 per cent against 14 per cent in urban areas. Regional differences are significant with the credit coverage at 25 per cent for the Southern Region and as low as 7, 8 and 9 per cent respectively in North Eastern, Eastern and Central Regions.

The extent of exclusion from credit markets can be observed from a different view point. Out of 203 million households in the country, 147 million are in rural areas – 89 million are farmer households. 51.4 per cent of farm households have no access to formal or informal sources of credit while 73 per cent have no access to formal sources of credit. Similar data are not available for non farm and urban households. Looking at the different sources of credit, it is observed that the share of non institutional sources reduced from 70.8% in

1971 to 42.9% in 2002. However after 1991, the share of non institutional sources has increased; specifically, the share of moneylenders in the debt of rural households increased from 17.5 % in 1991 to 29.6% in 2002. In urban areas the share of non institutional sources has come down significantly from 40% in 1981 to around 25 % in 2002.

Who are the excluded?

The financially excluded sections largely comprise marginal farmers, landless manual workers, self employed and unorganized sector enterprises, urban slum residents, migrants, ethnic minorities and socially excluded groups, senior citizens and women. While there are pockets of large excluded population in all parts of the country, the North East, Eastern and Central regions contain most of the financially excluded population.

Reasons for financial exclusion

There are a variety of reasons for FI.

1. Remote hilly and sparsely populated areas with poor infrastructure, physical access itself acts as a deterrent.
2. From the demand side, lack of awareness, low incomes/assets, social exclusion, illiteracy act as barriers.
3. From the supply side, distance from branch, branch timings, cumbersome documentation and procedures, unsuitable products, language, staff attitudes are common reasons for exclusion.

All these result in higher transaction cost apart from procedural hassles. On the other hand, the ease of availability of informal credit sources makes these popular even if costlier. The requirements of independent documentary proof of identity and address can be a very important barrier in having a bank account especially for migrants and slum dwellers.

In India, the period from 1969 to 1991 saw a huge increase in the branch outreach. The average population covered by a bank branch fell from 64,000 to 13,711. In 1991 along with reforms for liberalizing and opening the economy, financial sector reform aimed at deregulation, increased competition and strengthening the banking sector through recapitalization and adoption of prudential measures. The Indian banking industry today is quite robust and strong to be able to take on the challenges of achieving greater financial inclusion. The Reserve Bank has undertaken a number of measures with the objective of attracting the financially excluded population into the structured financial system. In November 2005, banks were advised to make available a basic banking 'no-frills' account with low or nil minimum balances as well as charges to expand the outreach of such accounts to vast sections of the population. Banks are required to make available all printed material used by retail customers in the concerned regional language. In order to ensure that persons belonging to low income group, both in urban and rural areas do not encounter difficulties in opening bank accounts, the know your customer (KYC) procedures for opening accounts has been simplified for those persons with balances not exceeding Rs 50000/- (about GBP 600) and credits in the accounts not exceeding Rs.100000/- (about GBP 1200) in a year. The simplified procedure allows introduction by a customer on whom full KYC drill has been followed. Banks have been asked to consider introduction of a General purpose Credit Card (GCC) facility up to Rs. 25000/- at their rural and semi urban braches. The credit facility is in the nature of revolving credit entitling the holder to withdraw up to the limit sanctioned. Based on assessment of household cash flows, the limits are sanctioned without insistence on security or purpose. Interest rate on the facility is completely deregulated.

A simplified mechanism for one-time settlement of overdue loans up to Rs.25,000/- has been suggested for adoption. Banks have been specifically advised that borrowers with loans settled under the one time settlement scheme will be eligible to re-access the formal financial system for fresh credit.

In January 2006, banks were permitted to utilize the services of non-governmental organizations (NGOs/SHGs), micro-finance institutions and other civil society organizations as intermediaries in providing financial and banking services through the use of business facilitator and business correspondent (BC) models. The BC model allows banks to do 'cash in - cash out' transactions at the location of the BC and allows branchless banking.

Other measures include setting up pilots for credit counseling and financial education. A multilingual website in 13 Indian languages on all matters concerning banking and the common person has been launched by the Reserve Bank on 18 June 2007.

Strategies and approach

At the regional level, a forum called the State Level Bankers' Committee (SLBC) has been in operation since nationalization. SLBC is a group of bankers and government officials and is convened by a bank having major presence in the State called the SLBC convener bank. It meets quarterly and reviews the banking developments in the State. At the district level, the district level committee functions; it is headed by the District Commissioner and is convened by a designated lead bank for the district. In early 2006, one district in each State was identified by the SLBC for 100 per cent financial inclusion. So far, SLBCs have reported having achieved 100 per cent financial inclusion in the Union Territory of Puducherry and in some districts in Haryana, Himachal Pradesh, Karnataka, Kerala and Punjab. Reserve Bank proposes to undertake an evaluation of the progress made in these districts by an independent external agency to draw lessons for further action in this regard. In the districts taken up for 100% financial inclusion, surveys were conducted using various data base such as electoral rolls, public distribution system, or other household data, to identify households without bank account and responsibility given to the banks in the area for ensuring that all those who wanted to have a bank account were provided with one by allocating the villages to the different banks. Mass media was deployed for creating awareness and publicity. The banks used different approaches to communicate the advantages of having a bank account. Bank staff or their agents who are usually local NGOs or village volunteers would contact the people at their households. Ration card / Electoral ID cards of the families were taken for fulfilling the simplified KYC norms. A photographer accompanying the bank team took photographs of all the persons who opened bank accounts on the spot. In most States, the product used for launching the program for financial inclusion is the 'No frills' accounts. In one State the farmer's credit card or KCC is being used ensuring first to credit rather than savings. In other States no frills account was followed by small overdraft facility or a general purpose revolving credit up to pre specified limit. Recognizing the need for providing social security to vulnerable groups, in some cases in association with insurance companies, banks have provided innovative insurance policies at affordable cost covering life, disability and health cover.

Cooperative banks and regional rural banks being local level institutions are well suited for achieving financial inclusion. These banks are being revived and strengthened with incentives for better governance. Being local institutions they are ideally suited for achieving FI.

The role of an efficient payments system for FI cannot be overstressed and efforts are being made to bring about Improvements in the payments system especially in the relatively less developed parts of the country.

Huge increase in no frills accounts

The outcome of the efforts made is reflected in the increase of 6 million new 'no frills' bank accounts opened between March 2006 and 2007. In view of their vast branch network (45000 rural and semi urban branches) public sector banks and the regional rural banks have been able to scale up their efforts by merely leveraging on the existing capacity. These banks are viewing FI as a huge business opportunity in an overall environment that facilitates enterprise and growth. It provides them a competitive advantage and defines a clear niche for their growth.

Self Help Groups

One of the ways in which access to formal banking services has been provided very successfully since the early 90s is through the linkage of Self Help

Groups (SHGs) with banks. SHGs are groups of usually women who get together and pool their savings and give loans to members. Usually there is a NGO that promotes and nurture these groups. National Bank for Agriculture and Rural Development has played a very significant role in supporting group formation, linking them with banks as also promoting best practices. The SHG is given loan against guarantee of group members. The recovery experience has been very good and there are currently 2.6 million SHGs linked to banks touching nearly 40 million households through its members. Banks provide credit to such groups at reasonable rates of interest. However the size of loans is quite small and used mostly for consumption smoothening or very small businesses. In some SHGs, credit is provided for agricultural activities and other livelihoods and could be several times the deposits made by the SHG. Most of the SHGs have been linked to public sector banks in view of the latter's dominant presence in the rural areas. The foreign banks and private sector banks have approached the access issue through either setting up relatively lower cost non bank companies for providing small value retail loans or have partnered with micro finance institutions that provide financial services to the relatively higher risk segments of the population. Microfinance has drawn attention to an entire sector of borrowers who had been previously poorly served by the formal financial sector - and MF has demonstrated how to make lending to this sector a viable proposition. However the rates of interest charged are quite high, typically 24 to 30 percent, mainly on account of the high transaction cost for the average loan size that can be quite small. Compared to the informal sector, perhaps the rates are lower, but issues are raised whether these rates are affordable - in the sense whether they would leave any surplus in the hands of the borrowers and lead to higher levels of living. For commercial banks, the lower cost of funding, advantages of size and scale gives scope for cross subsidization and their interest rates are more competitive compared to the MFIs, but they have not been as successful in dealing with the last mile issue. The partnering with SHGs and MFIs with reasonable cost of funding by the banks has been seen as a more optimal approach till now. As indicated earlier, a recent important regulatory measure is the permission given to banks to use post offices, cooperative societies, non government organizations set up as trusts or societies, as business correspondents (agents) for doing branchless banking after conducting due diligence on such intermediaries. Agency risk is sought to be minimized by using well respected local organizations and use of IT solutions for tracking transactions in the bank accounts. Many banks are exploring the use of this model to increase their outreach and deliver doorstep banking services at lower cost. The viability and scalability of the model would require some flexibility in charging of interest rates or services charges to cover costs.

IT solutions for financial inclusion

The use of IT solutions for providing banking facilities at doorstep holds the potential for scalability of the FI initiatives. Pilot projects have been initiated using smart cards for opening bank accounts with biometric identification. Link to mobile or hand held connectivity devices ensure that the transactions are recorded in the bank's books on real time basis. Some State Governments are routing social security payments as also payments under the National Rural Employment Guarantee Scheme through such smart cards (see pictures below). The same delivery channel can be used to provide other financial services like low cost remittances and insurance. The use of IT also enables banks to handle the enormous increase in the volume of transactions for millions of households for processing, credit scoring, credit record and follow up.

Role of Government

State Governments can play a pro –active role in facilitating FI. Issuing official identity documents for opening accounts, creating awareness and involving district and block level functionaries in the entire process, meeting cost of cards and other devices for pilots, undertaking financial literacy drives are some of the ways in which the State and district administration have involved themselves. India Post is also looking to diversify its activities and leverage on its huge network of post offices; the postman's intimate knowledge of the local population and the enormous trust reposed in him. Banks are entering into agreements with India Post for using post offices as agents for branchless banking.

The Finance Minister in his budget for 2007-08 has announced the setting up of two funds for FI; the first called Financial Inclusion Fund for developmental and promotional interventions and the other called Financial Inclusion Technology Fund to meet cost of technology adoption of about $ 125 million each. The scope of these funds is being worked out. Setting up of financial literacy centers and credit counseling on a pilot basis, launching a national financial literacy campaign, forging linkages with informal sources with suitable safeguards through appropriate legislation, evolving industry wide standards for IT solutions, facilitating low cost remittance products are some of the initiatives currently under way for furthering FI.

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