Broadening Access to Finance

chapter 3

Financial sector policies in India have long been driven by the objective of increasing financial inclusion, but the goal of universal inclusion is still a distant dream. The network of cooperative banks to provide credit to agriculture, the nationalization of banks in 1969, the creation of an elaborate framework of priority sector lending with mandated targets were all elements of a state-led approach to meet the credit needs of large sections of the Indian population who had no access to institutional finance. The strategy for expanding the reach of the financial system relied primarily on expanding branching, setting up special purpose government sponsored institutions (such as regional rural banks (RRBs) and cooperatives) and setting targets for credit to broad categories of the excluded. Its success has been mixed, and has been showing diminishing returns.

A new approach to financial inclusion is needed that builds on the lessons of the past. It will require a change in mindset on the part of policymakers, practitioners, and other stakeholders in India to figure out effective ways to provide financial services to the poor. It should lead to a set of financial sector reforms that explicitly prioritize inclusion. We note some important lessons from India's past experience:

- Financial inclusion is not only about credit, but involves providing a wide range of financial services, including saving accounts, insurance, and remittance products. An exclusive focus on credit can lead to undesirable consequences such as over-indebtedness and inefficient allocation of scarce resources. Moreover, credit provision, without adequate measures to create livelihood opportunities and enhance credit absorption among the poor will not yield desired results.
- Perhaps the most important financial services for the poor are vulnerability reducing instruments.[1] Thus access to safe and remunerative methods of saving, remittances, insurance, and pensions needs to be expanded significantly. Within insurance, crop insurance for farmers and health insurance for the poor in general, are major vulnerability reducers. A significant expansion in coverage is needed, even while action is taken on the real side to reduce the factors creating vulnerability (such as broader access to irrigation, agricultural extension services, and preventive, as well as actual, health care).
- Efforts at financial inclusion need to move away from sectors to segments of people that are excluded. Past efforts have focused largely on agriculture. As the Indian economy diversifies and more people move away from farming, there is an urgent need to focus on other segments as well, for instance the poor in urban areas. Moreover, sector-specific approaches result in benefits that often accrue to non-poor recipients, as in the case of subsidized agriculture credit.
- Past strategies to expand inclusion are reaching seriously diminishing returns.
    - While mandated branching, especially by public sector banks in rural areas, has made banks easier to reach for significant portions of the population, these branches have not gone out of their way to attract the poor. Rural branches are seen as a burden rather than an opportunity by the increasingly profit-oriented public sector. At the same time, it appears that more branching itself cannot be the way to reach the poor, since the poor in richly branched urban areas have no more access than the poor in rural areas.
    - Priority sector norms do force a focus on particular sectors. But because they are now so broad in coverage, banks migrate towards the bankable within the priority sector rather than the excluded, with those lucky enough to get themselves classified as priority sector

enjoying access over and above what they would otherwise normally get.

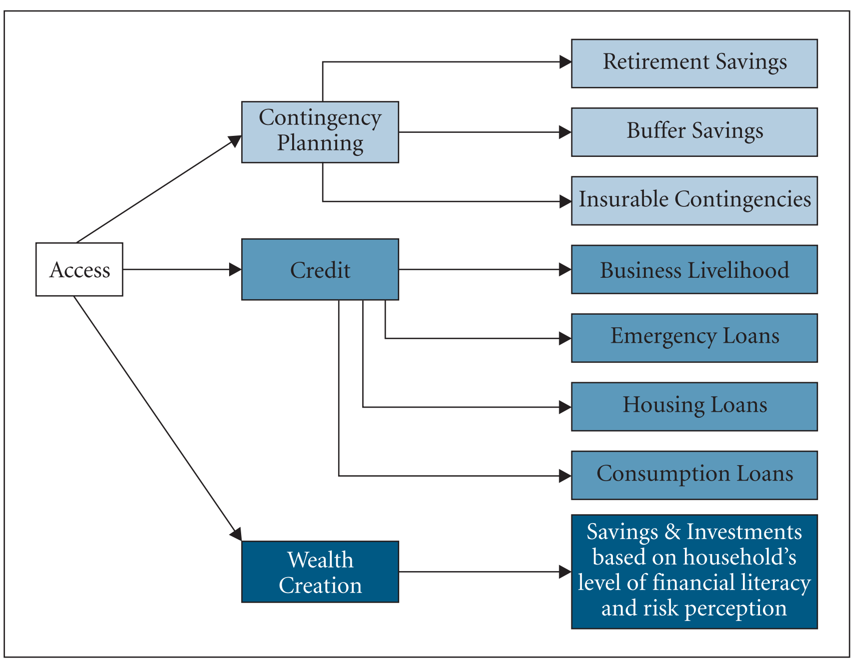
- ○ Interest rate ceilings for small loans further reduce commercial banks' desire to service the truly excluded—the higher fixed costs and higher perceived credit risk associated with small loans imply lenders need higher, not lower, interest rates to meet demand.[2] When a low interest rate is mandated in the face of tremendous unfulfilled demand for credit, it has three effects. First, a market determined interest rate is often charged, but the difference between the ceiling and the true rate is made up through hidden fees or through bribes (and when bribes are paid to secure the loan, the incentive to repay is severely diminished). Second, the very poor, who have the least ability to pay these additional charges, are further excluded. Third, a plethora of bureaucratic norms and paperwork is imposed on loan officers to counter the possibility of corruption, which further reduces the flexibility or the attractiveness of the loans. The need to remove interest rate ceilings and replace them with transparent but market-based pricing has been echoed by past Committees that have seriously addressed the issue, but the political unwillingness to make changes has ensured that the poor are excluded from the formal sector and driven further into the hands of moneylenders.

- There is a clear need to increase the commercial viability of reaching the poor. Product innovation, organizational flexibility, and superior cost efficiency are essential in reaching the excluded (as cell phone companies have discovered) and offering them financial services that they will want to use. Competition, technology, as well as the use of low cost, local organizations for outreach will have to play a much greater role in any strategy. The role of the government should be to attempt to increase the returns and reduce the costs of servicing the financially excluded, even while expanding the desire and the ability of financial firms to compete for such business. By necessity, this will imply a greater tolerance for innovation and risk, which is not inappropriate so long as that risk does not become systemic.
- The Committee recognizes, however, that greater commercial viability cannot be truly achieved for all sections of the poor, and therefore some kind of mandated coverage will always be required. The key is to move the primary strategy towards innovation and commercial viability, with more carefully targeted mandates seen as filling the gaps, rather than having broad mandates as the central instrument as is current practice.

DEFINING ACCESS IN A FINANCIALLY INCLUSIVE SYSTEM

Financial inclusion, broadly defined, refers to universal access to a wide range of financial services at a reasonable cost. These include not only banking products but also other financial services such as insurance and equity products (see Figure 1). Households need access to finance for several purposes, the most important being for contingency planning and risk mitigation. Households build buffer savings, allocate savings for retirement (for example via pension plans) and purchase insurance and hedging products for insurable contingencies. Once these needs are met,

Figure 1: Household Access to Financial Services



Source: IISS, 2007.

households typically need access to credit—for livelihood creation as well as consumption and emergencies (in the event that they do not have savings/insurance to fund them). Finally, wealth creation is another area where financial services are required. Households require a range of savings and investment products for the purpose of wealth creation depending on their level of financial literacy as well as their risk perception.

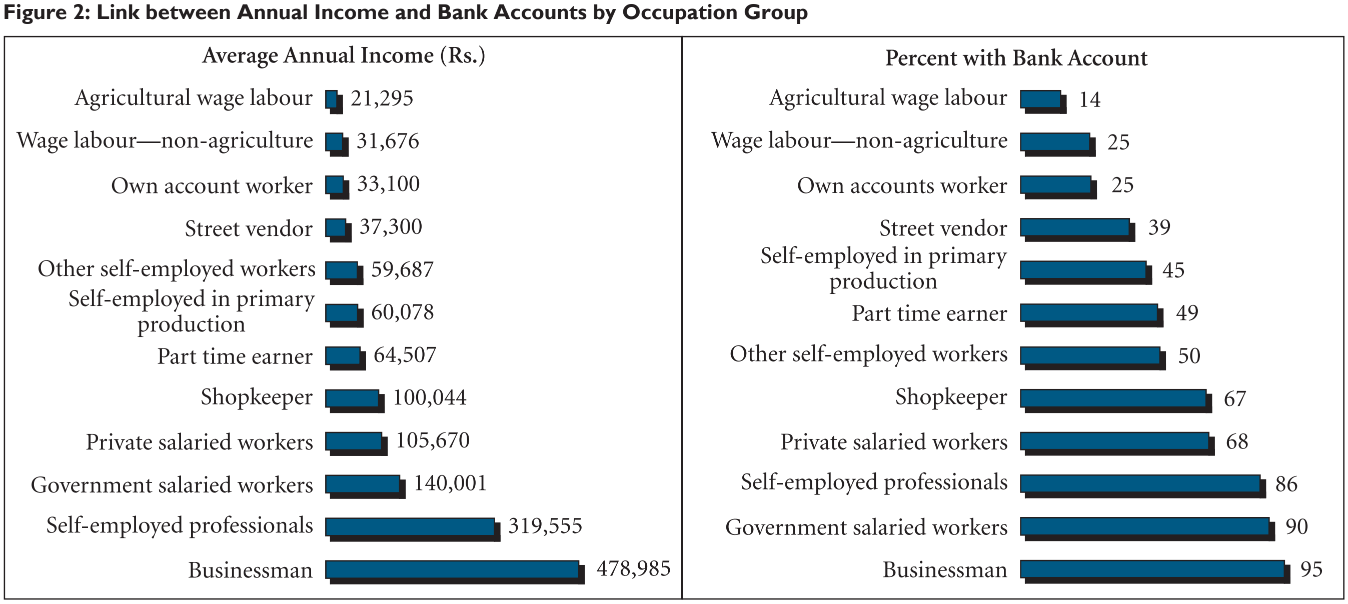
FINANCIAL INCLUSION IN INDIA—AN UPDATE OF THE EVIDENCE[3]

Broad assessment

India's poor, many of who work as agricultural and unskilled/semi-skilled wage labourers, micro-entrepreneurs and low-salaried worker, are largely excluded from the formal financial system (Figure 2). Over 40 per cent of India's working population earn but have no savings.[4] Even accounting for those with financial savings, too large a proportion of the poor lie outside the formal banking system. For example, only 34.3 per cent of the lowest income quartile has savings, and only 17.7 per cent have a bank account. By contrast, in the highest income quartile, 92.4 per cent have savings and 86.0 per cent have bank accounts. Similarly, 29.8 per cent of the lowest income quartile had taken a loan in the last two years, but only 2.9 per cent had loans from banks (about one tenth of all loans), while 16.3 per cent of the highest income quartile had loans and 7.5 per cent had loans from banks (about half of all loans).

The rich-poor divide has replaced the conventional rural-urban divide in access to financial services, as measured by the distribution of savings accounts. It is true that headline statistics on access to banks seem to convey that there is a rural-urban divide in access to banking services. The population served per bank branch in rural India is approximately 18,000 while in urban India is 5,000 (World Bank-NCAER *Rural Financial Access Survey*, 2003). But 80 per cent of those without savings reside in the rural areas. For those in higher income brackets, access to banks in rural areas is not vastly different from access in urban areas. Banks are approaching near 100 per cent coverage of individuals with incomes above Rs. 2 lakh, irrespective of geographical location. In urban India, 34 per cent of workers in the lowest income quartile have savings, and of

Figure 2: Link between Annual Income and Bank Accounts by Occupation Group

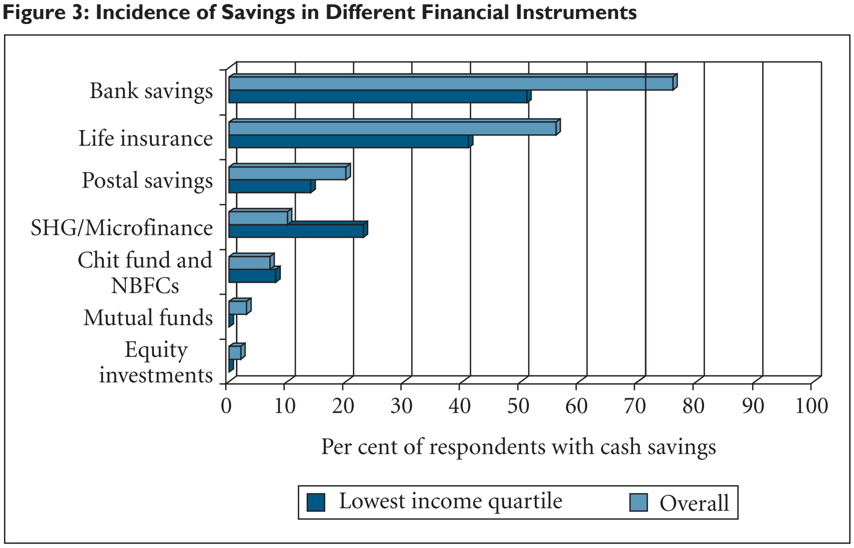


Source: IISS, 2007.

whom only 60 per cent have bank savings account, while in the highest income quartile, 92 per cent have financial savings and of whom 96 per cent have bank savings account. A similar trend is evident for rural India where 83 per cent of rural workers with annual incomes above the national average (Rs. 71,000 for the Survey) have bank accounts. Even inter-state differences in banking coverage can largely be explained by large differences in incomes and savings among states.[5] Though we cannot rule out the possibility of other sources of causality, income seems to be a big factor explaining access to financial services.

Public ownership of financial services also does not contribute significantly towards expanding access. The clientele of private or foreign banks located in rural areas is not very different from the clientele of public sector banks (see Chapter 4). Similarly, the poor's access in the public sector dominated rural areas is not significantly higher than in urban areas (though costs of access may indeed be higher in rural areas). Finally, branching as a strategy to improve inclusion itself seems to have reached diminishing returns. The poor have no more access in the richly branched urban areas than in the rural areas. Inclusion has to be more than opening up more branches.

Figure 3: Incidence of Savings in Different Financial Instruments



Source: IISS, 2007.

Specific needs of the poor and extent to which met by formal system

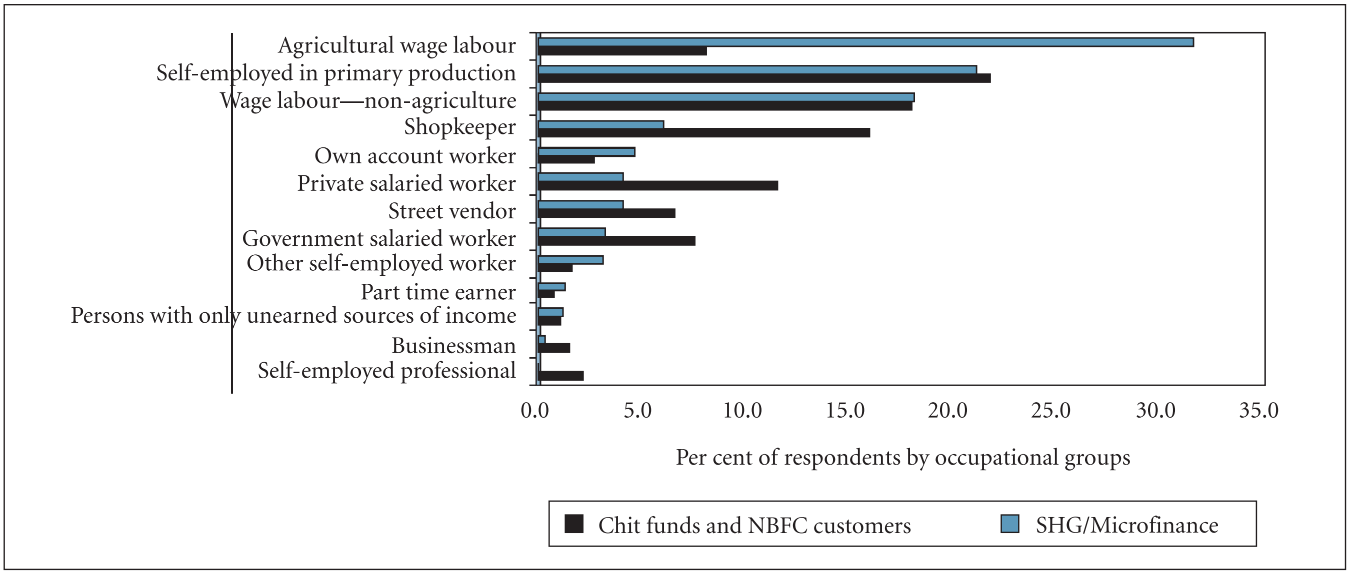
The use of financial services is not only a function of economic criteria but is also dependent on socio-cultural parameters and risk perception, an understanding of which is critical to increase usage—not just availability—of formal financial services. What is particularly of concern is the extent to which the poor use financial services, but sourced from the informal rather than the formal financial system.

1. Savings
   Seventy-six per cent of respondents with savings reported keeping their money in bank savings accounts. Other popular savings instruments include life insurance and postal savings (Figure 3). In the lowest income quartile, the most preferred savings instruments were bank savings accounts though only 50 per cent of those with savings had bank accounts. Life insurance and informal savings schemes like self-help groups and microfinance institutions were the other preferred instruments. Over 20 per cent of respondents in the lowest income quartile held savings in chit funds and self-help groups/microfinance, though the absolute number of people saving in these informal savings schemes is still small—approximately 10 per cent of those with cash incomes or 33 million. Over 50 per cent of the clients saving with SHGs/microfinance institutions were agricultural wage labourers and self-employed farmers, while 30 per cent of chit fund members belonged to this category (Figure 4).

   Few people save for retirement, with less than 10 per cent of the paid workforce saving explicitly for retirement through employer-sponsored schemes, or voluntarily through public provident fund, life insurance and mutual fund products.[6] In the lowest income quartile, 3.7 per cent of respondents in the category saved for old age security.

   Higher income categories are more likely to diversify into other financial instruments. The RBI Annual Report, 2006–07, states that the share of household financial savings in shares and debentures increased from 1.1 per cent in 2004–05 to 6.3 per cent in 2006–07.[7] The Survey

Figure 4: Use of Informal Savings Schemes by Occupation Category



Source: IISS, 2007.

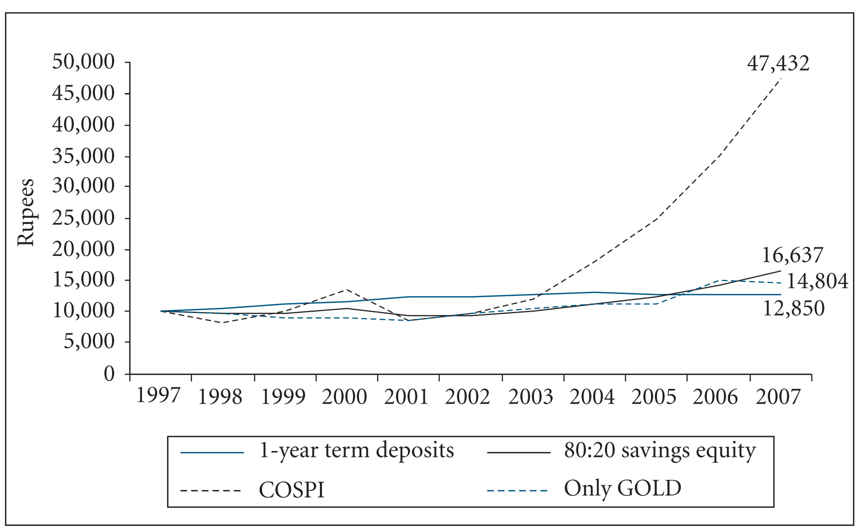
reveals that increased investor interest in equities and mutual funds figured prominently among respondents citing wealth creation and investment as their main motivation for savings.[8,9] Although 30.0 per cent of equity investors and 32.0 per cent of mutual fund investors report an annual income of below Rs. 2.5 lakh, they comprise less than 1 per cent of the population in this income category. In the income category above Rs. 2.5 lakh, over 29 per cent have invested in mutual funds and 20 per cent in equities. The one common quality among these investors appears to be education—over three-fourths of investors are graduates. Less than 4 per cent of the investors are women.

Bank savings are overwhelmingly the most popular savings medium even among those who appear to have choices in deployment of their savings. However, real returns on bank savings have paled in comparison with returns on equity especially in recent years (Figure 5). The poor have largely missed out on the boom in the equity markets for a number of reasons, including a high priority on security and liquidity, and perhaps a limited understanding of the economic effects of inflation on savings. Worse, the tax on bank deposits has increased the gap in returns between bank savings and equity.[10] This emphasis on bank deposits is beginning to change slowly at the margin as more low income households invest in mutual funds and equities.

2. Insurance

The participation of low-income groups in life insurance, the second most preferred savings instrument after bank savings deposits, is still very limited. Life insurance is the preferred choice to deal with insurable contingencies, particularly premature death. One-third of all paid workers have some life insurance protection. However, only 14 per cent of

Figure 5: Returns on Various Savings Instruments for an Investment of Rs. 10,000 in 1997



Source: ICICI Bank research.

Note: COSPI is an equities index developed by the Centre for Monitoring Indian Economy which is based on all listed Indian companies.

people in the lowest income quartile and 26 per cent in the second quartile have life insurance as against 69 per cent in the highest income quartile. While the elaborate sales and distribution model has contributed to the popularity of life insurance, this has come at considerable cost by way of high commissions and a large per cent of lapsed policies.[11] Policy lapses are low only in the highest income quartile, while in all other segments at least 20 per cent respondents have had a policy lapse. The penetration of non-life insurance products is negligible. For example, only 1 per cent of the population appears to have medical insurance.

3. Credit
The poor borrow predominantly from informal sources, especially moneylenders and relatives/friends. In the lowest income quartile, over 70 per cent of loans taken were from these sources. Only 10 per cent of respondents took a loan from a bank in the last two years. Correspondingly, in the highest income quartile, banks were the most preferred followed by relatives/friends (Figure 6). A large proportion of borrowers, irrespective of income, sourced their loans from friends and relatives (though the fact that nearly half these loans are made at interest rates above 36 per cent per annum suggest they may include informal commercial sources such as shop keepers that are well-known to the poor). Even among the urban poor, a large per cent of their housing finance needs are met by informal sources.

Medical and financial emergencies were the main reason for household borrowing accounting for 42 per cent of all loans made in the past two years. For the lowest income quartile population, the incidence of emergency loans was highest at almost 50 per cent, with the top three loan sources being moneylenders, friends and relatives and SHGs. Nearly 90 per cent of Survey respondents in this quartile relied on informal sources for credit. In the highest income quartile, the incidence of emergency loans was around 35 per cent, mostly for financial emergencies. The Survey results on incidence of financial and medical emergency loans among the various income quartiles revealed that medical emergencies were particularly high for the lowest income quartile. Loans for medical emergencies decline substantially as income levels increase. Loans taken for emergency purposes created an unsustainable amount of debt for the lowest income segment with outstanding debts out of emergency loans resulting in debt on average exceeding a full year's earnings.

The high dependence on informal sources in turn implies that bulk of the borrowing by the very poor is at very high interest rates. Almost half the loans taken by the lowest income quartile carry annual interest rates above 36 per cent (Figure 7). While the majority of small loans by banks are at low interest rates, only a small fraction of the loans the poor get are from banks. It appears that the low interest rate ceiling may be a factor leading to the higher-credit-risk poor being denied credit by the formal sector.

Given the extremely high demand for credit, interest rate ceilings could simply increase the extent to which costs are recovered through fees and other mechanisms. A 2003 World Bank survey revealed that despite lower nominal interest rates, rural borrowers paid substantial unofficial borrowing costs in the form of bribes and the time taken to process a loan.[12] While the per cent of bribes as a share of the loan were highest in government sponsored schemes (around 42 per cent of the loan) and lowest for banks (10 per cent of the loan), the time taken to process loans was the longest for commercial banks in rural areas. Households generally received significantly less than the total amount of loan they applied for, and the data suggest that speed of loan approval was positively correlated with the amount of bribe paid. The Survey covered just two Indian states (Uttar Pradesh and Andhra Pradesh),

Figure 6: Sources of Loan by Income Group

Loan sources	Percentage of persons in income quartile who have taken loan from sources in last two years			
	Lowest income quartile	Second income quartile	Third income quartile	Highest income quartile
Relatives/friends	39.2	34.4	33.2	32.0
Moneylenders	39.8	33.2	25.8	14.8
Banks	9.6	20.7	33.3	45.8
Self-help groups	9.7	8.4	3.3	3.4
Cooperative societies	5.4	4.9	6.5	7.4
Chit funds/NBFC	1.6	1.9	1.5	1.2
Microfinance Institutions	1.1	1.4	1.2	0.9
Others	1.0	0.9	0.8	1.4

Source: IISS, 2007.

however, anecdotal information supports the findings of this survey and strengthens the belief that the cost of access to credit often goes well beyond nominal interest rates charged on the loan.

Other sources support our conclusion that large segments of India's poor households continue to be shut out of mainstream finance. More worrying, according to some measures, access is actually declining. The All India Debt and Investment Survey, conducted every 10 years, documents how Indian cultivators' reliance on formal debt sources increased substantially from 18 per cent in 1961/62 to 63 per cent in 1981/82, but this progress was reversed in the next two decades as the share of cultivators' debt from moneylenders increased from 18 to 30 per cent between 1991 and 2002. The National Commission for Enterprises in the Unorganized Sector points out that microenterprises with investments below Rs. 0.5 million constitute over 90 per cent of small enterprises in the country and contribute 30 per cent to industrial production but receive just 2 per cent of net bank credit.

Figure 7: Annualized Interest Rates Paid by Income Groups

Income quartile	Percentage of persons in the income quartiles paying interest at the rate			
	<=12% pa	12%–24% pa	24%–36% pa	>36% pa
Lowest income quartile	16.0	16.9	18.7	48.4
Second income quartile	22.8	18.8	18.7	39.7
Third income quartile	29.1	26.1	18.7	26.2
Highest income quartile	40.4	24.5	11.7	23.4
Total	22.6	19.4	17.7	40.4

Source: IISS, 2007.
Note: Figures are indicative and do not take into account the fact that some sources provide only short-term loans.

ASSESSING THE STRATEGY FOR INCLUSION

The broad strategy for expanding the reach of the financial system had mixed results. The strategy relied primarily on expanding branching into rural areas, setting up special purpose government sponsored institutions (such as regional rural banks and cooperatives) and setting targets for credit to broad categories of the excluded. Rural branches have not been profitable, and there is little interest among private and public sector banks in opening new branches there. It is fair to question whether the stationing of highly-paid urban-recruited staff in short-term postings in rural areas is conducive to the development of local knowledge and low cost efficient delivery of financial services, especially credit. Even if the staff make local contacts and understand local needs, the controls that central offices have to exercise over them allow them little leeway for taking initiative. Indeed, the predominant lender to the poor is still the moneylender, in part because he is flexible, does not need documentation, is prompt, and can respond to his client's emergency needs very well.

Credit

Special purpose government sponsored local institutions such as rural cooperatives did increase access to credit, but they are experiencing serious financial problems, in part because they did not have the right governance and incentive structures. As indicated by the Vaidyanathan Committee, cooperatives unfortunately became agencies solely for credit dispensation.[13] Upper tiers were created to provide refinance for the lower. This resulted in a structure driven by borrowers at all levels, with each layer adding costs. Indeed, the whole concept of top-down financing inherent in the Indian cooperative sector is in sharp contrast to the cooperative movement in other countries, where member savings are channelled through careful member control into local loans. This bottom-up flow of financing, coupled with member monitoring, ensures that loans are carefully made and repayment rates are high. Loan assessment and monitoring in the cooperative movement in India has been much more lax, in part because of the easy availability of refinance from outside, and because of limited control exercised by those whose funds are being employed.

Cooperatives also suffer from a number of other disadvantages. Their inability to lend well has increased the interest cost of deposit financing. They have high transaction costs owing to over-staffing and salaries unrelated to the magnitude of business. Actual repayments are influenced by ad-hoc government decisions to suspend, delay or even waive recovery. All these impediments have ensured they have played a smaller role than they could have.[14]

Priority sector lending requirements played a useful role in facilitating the provision of bank credit to underserved sectors and sectors identified as national priorities.[15] It is probably fair to say that banks' loan portfolios in agriculture, microfinance, small-scale industry and other sectors (that were neglected with respect to credit provision) would have seen a more modest growth in the absence of priority sector lending norms. If an objective of priority sector lending, however, was to direct credit to those *segments* that are truly underserved, the outcomes are not encouraging. All banks, public and private, have consistently missed their targets for credit provision under the direct agriculture segment (though public sector banks have done relatively better), which is largely intended for farmers.[16] Similarly, they have missed priority sector lending targets for the 'weak and vulnerable' category.

Dilution in priority sector norms also contributed to a reduced focus on underserved segments. The bulk of increase in credit to agriculture was accounted for by increase in indirect finance to agriculture, which includes activities that can be considered commercially viable. Another example is the loans to housing. Housing loans were introduced into the priority sector framework in the 1990s to spur the development of this market. The ceiling on housing loans eligible for priority sector treatment was initially set at Rs. 5 lakh; this limit was rapidly increased to Rs. 20 lakh by 2006. To qualify for a housing loan of Rs. 20 lakh, an individual needs an annual income of at least Rs. 4 lakh per year. Surely this is not the category of borrowers that need to be targeted via mandated lending!

The dilution in priority sector norms over time was a reaction to the lack of profitable lending opportunities when norms were more tightly specified. The fundamental dilemma is obvious. Profit-seeking banks will look for all lending opportunities that are profitable. Priority sector norms will expand access only if they make banks do what they would otherwise not do, which almost by definition is unprofitable. There is therefore a delicate balance in setting priority sector norms and eligible categories. High priority requirements and narrow eligible categories targeted at those who truly do not have access could lead to greater access to credit, but could reduce bank profitability considerably. Essentially, banks would be making transfers to the needy, a role better played by the government.

Insurance

Government efforts at providing risk mitigation have also been less than adequate, and have unfortunately hindered the development of private efforts. Recognizing the need for risk mitigation, the government set up a mandatory National Agricultural Insurance Scheme (NAIS) for farmers, which requires that farmers borrowing for 16 specific crops purchase crop insurance through the NAIS. However, the payout from this scheme for the past six years has been in excess of the premia received. This is a direct consequence of the caps imposed on the premium rates of oilseeds and food crops—less than 1.5 per cent and 3.5 per cent or the actuarial assessed rates for food crops and oilseeds respectively. Though the broad structure of the NAIS is sound, a key problem is the significant delays in claims settlement (9–12 months on average). These delays could be significantly reduced by strengthening the yield data collection process, combining early trigger indices into NAIS to make part payments during the crop cycle with final settlements made on the area yield measured, and most importantly by moving towards an actuarial regime where the Agriculture Insurance Company of India (AICI) could receive upfront government support and would bear residual insurance risks.[17] For now, the highly subsidized nature of this insurance has distorted farmers' views on what the true price of insurance should be, and discouraged private initiatives to provide crop insurance. Subsidized livestock insurance schemes have had a similar effect. Insurance against agricultural price fluctuation has been hampered, as small farmers are unable to exercise hedging options that are available to larger farmers.

In summary, the past strategy for inclusion had mixed results**.** While the public sector did create a rural network, that network did not bring enough of the poor into the formal system, and the rural network weighs on public sector bank profitability (see Chapter 4). The cooperative system is in serious financial difficulty. Narrowly defined priority sector norms can force banks to lend, but again by impairing profitability. The focus on increasing credit in the absence of appropriate products for risk mitigation led to over-indebtedness among the poor. As the financial sector becomes more competitive, and as banking privileges get eroded, it will become more difficult and unwise to compromise bank profitability by mandating that banks take on the burden of financing inclusion. Instead, the approach has to be to make inclusion more profitable.

Microfinance

Microfinance is the fastest growing 'non-institutional' channel for financial inclusion in India. A key factor that influenced the success of microfinance was its ability to fill the void left by mainstream banks that found the poor largely uncreditworthy, and were unable (or unwilling) to design products that could meet the needs of this segment in a commercially viable manner. Using group-based lending and local employees, microfinance provides financial services (largely credit) using processes that work, and in close proximity to the client. These qualities facilitated the proliferation of microfinance from a virtually non-existent activity in 1990 to a small, but increasingly important, source of finance for India's poor.[18]

Two models of microfinance are practiced in India: (*i*) the Self-Help Group (SHG)-Bank linkage model where commercial banks lend directly to SHGs formed explicitly for this purpose and (*ii*) the Microfinance Institution (MFI) model where MFIs borrow funds from banks to on-lend to microfinance clients, many of whom form joint liability groups for this purpose. The first model is the predominant channel for microfinance in India and is a good example of a meaningful liaison between commercial banks and informal SHGs. As of end-March 2007, 29 lakh SHGs had been formed and total loans outstanding to these groups was about Rs. 11,000 crore.[19] Credit provided by MFIs to microfinance clients was about Rs. 3,500 crore in end-March 2007, 80 per cent of which was provided by less than 20 large MFIs which are registered as NBFCs/Section 25 companies. The bulk of microfinance activity was concentrated in South India, though this is beginning to change.[20]

There is evidence that an increase in microfinance lending is associated with a lower incidence of borrowing from moneylenders, especially for low income segments. The IISS 2007 survey reveals that in the lowest income category, respondents who are members of SHGs appear to borrow less from moneylenders and friends and family than those who are not members of SHGs. It also appears, however, that the demand for credit of SHG members is appreciably high, and this group still needs to source a large share of its credit from elsewhere (Figure 8).

Microfinance also appears to help its clients in their efforts to reduce poverty, though more careful randomized evaluations are needed to fully assess its impact.

Figure 8: Credit Sources for Loans Taken in Past Two Years by Income Groups

Income group (Rs. lakh)	<=0.3	0.3–0.6	0.6–0.9	>0.9
	Members of SHGs			
Relatives/friends	24.8	27.0	32.9	25.3
Banks	7.8	15.0	19.9	36.8
Self-help groups	40.5	36.7	32.6	19.2
Money lender	33.3	21.3	18.4	14.9
Others	5.0	6.8	5.8	13.8
	Non-members of SHGs			
Relatives/friends	41.4	35.2	34.7	30.6
Banks	11.3	22.8	38.7	51.0
Cooperative society	6.1	5.3	5.6	7.4
Money lender	40.1	34.5	21.8	13.6
Others	7.6	7.4	4.5	4.2

Source: IISS, 2007.

Note: Figures relate only to SHG members who have regular cash incomes. Numbers denote percentage of respondents in each category that had borrowed from a particular source. Cells add up to more than 100 due to borrowing from multiple sources by respondents.

A recent report by the Grameen Foundation took stock of the evidence on the impact of microfinance on poverty alleviation.[21] It highlighted several studies that indicated microfinance plays a significant role in poverty reduction. For example, one study by Khandkar suggested that microfinance was responsible for 40 per cent of the entire poverty reduction in Bangladesh.[22] Another study of SEWA Bank, Gujarat, found that SEWA Bank clients had higher levels of income than others in the area who were also self-employed, but did not participate in SEWA Bank's programmes.[23] The Report also found evidence that microfinance had a wider positive impact on socio-cultural issues, such as women's empowerment, nutrition and contraceptive use.

Despite its success, the future growth of microfinance is constrained by a number of factors. An important issue is the ability of MFIs to raise financing. Given the large estimated demand for microcredit, MFIs need multiple sources of financing, apart from the traditional loan financing from banks.[24] Other constraints include an unclear regulatory environment and the lack of well-developed management information systems and an adequate supply of trained management talent to facilitate sustainable scaling up.

A NEW STRATEGY FOR INCLUSION

Any comprehensive and sustainable response to addressing issues of financial inclusion must necessarily factor in the role of the market. This is because efficiency, innovation and cost-effectiveness are key to serving the financial needs of the poor. The financial sector does not ignore the poor because of biases, but because the transaction costs in serving them are high. Initiatives that reduce these costs will allow service providers to begin thinking of financial services for the poor as a business opportunity and not as an act of charity. Policy initiatives need to make financial services for the poor as attractive as those for the rich, and increase competition to serve them. To reduce transaction costs, public policy must facilitate the use of technology and the creation of low cost organizational structures to reach the poor.

A new strategy for increasing access to financial services will require the creation of a vibrant ecosystem that supports financial inclusion. This calls for changes on several fronts. Six areas are identified and are described in detail below:

An organizational structure that facilitates inclusion

The starting point for a vibrant ecosystem for financial inclusion is to ensure that the organizational architecture supports and creates institutions that can reach the poor. The Committee recommends a two-pronged approach—first, to facilitate the creation of small finance banks, and second, to strengthen the linkages between large and small financial institutions. Both measures should be pursued with equal vigour.

There is a growing consensus around the world that small business/farmer credit is best delivered by local small private or voluntary

Institutions, especially if standardized credit information is limited. Experiences in US, Europe, the Philippines, and other countries in the creation of small and local financial institutions are a case in point. These institutions should be 'local' because someone who is part of the locality has much better information on who is creditworthy than someone who is either posted temporarily from a city, or someone who takes the bus everyday from the nearest town. They are also better able to understand local farmer and business needs. 'Small' because the centre of decision making is close to the loan officer—he can get approval directly from the manager without the documentation, delays, and loss of information that would be incurred if he had to get approval from head office. 'Private' or 'voluntary' because the manager has the right incentives in handling flexible, low documentation, loans if he has a significant stake in the enterprise and its future.[25] And finally, local, small, private or voluntary institutions have the low cost structure and low staffing costs (because their local hires will be paid at local wage rates instead of at city rates) that allow small loans to be profitable. In fact, successful micro-lenders, the moneylender and the microfinance institutions have precisely these characteristics.

Many of the government initiatives in this regard suffer from one or more deficiencies with respect to local private or voluntary institutions. Large banks do not have the decentralized loan making authority, the local knowledge, the incentives (in the case of public sector banks), or the low cost structures to make local loans. More automated credit information with wide coverage would help (see Chapter 7). This is not to say that large banks have no role in financial inclusion—they do have an important direct role in offering 'commoditized' products such as checking accounts, where scale economies can be brought to bear, and an indirect role through local partners in offering customized products. Hence the recommendation of a two-track approach that involves the creation and promotion of small finance banks as well as the strengthening of linkages between large banks and small local entities to facilitate the retailing of large banks' financial products to small clients.

The Indian financial landscape is dotted with a number of small, local financial institutions. As mentioned in 'Assessing the strategy for inclusion', many of these, especially those in the public sector, ran into difficulties, and are now in various stages of transformation. Various categories of small banks were created, but with less than satisfactory success in banking the poor. The RRBs and the Urban Cooperative Banks (UCBs) are testament to this. A key problem faced by these institutions was that the quality of lending was compromised due to various reasons. In the case of RRBs, the wage structure for RRB staff was equalized with their higher wage national commercial bank counterparts, resulting in a cost structure that was unprofitable. High profile crises in two UCBs in 2001–02 led to a decline in public confidence in UCBs.[26] These institutions were largely denied the key factors that are crucial to small banks' success, namely the flexibility and independence to adopt low cost, innovative processes and structures to make small-scale banking viable.

A large number of commentators believe, based on historical evidence, that small banks will be unviable in India. They question the probity of small promoters, as well as the profitability of these banks given high fixed costs. This Committee recognizes that small banks have not distinguished themselves in India in the past, often because of poor governance structures, excessive government and political interference, and an unwillingness/inability of the regulator to undertake prompt corrective action. These are not the banks the Committee wants, and the Committee would call for substantial care in who is licensed, as well as greater regulatory oversight. There is, however, no necessary link between size and probity. Indeed, the larger number of potential applicants for small banks suggests the regulator can be far more selective in applying 'fit and proper' criteria. Moreover, technological solutions can bring down the costs of small banks substantially, even while increasing their transparency.

This Committee believes that notwithstanding the checkered history of small banks in India, a strong emphasis on good quality lending, low cost structures, effective governance and management, and tight prudential norms, could make small banks very useful to provide financial services to the poor. The Local Area Bank (LAB) scheme, that bears some resemblance to our proposal, was prematurely discontinued, and certainly has not resulted in the catastrophic failure that some associate with small banks.[27] Indeed, Box 1 documents the case of small banks that have achieved success by leveraging these strengths.

Box 1: A Case for Small Banks

Experience in Indonesia and the Philippines showed that the establishment of small banks has been a critical factor for increasing the provision of financial services to the poor (ADB, 2004). For example, several rural banks in the Philippines that cater to small savers and borrowers were offered incentives in the form of low minimum capital requirements, lower reserve requirement ratio and exemption from various taxes for the initial five years of operations. These incentives enabled these banks to offer higher interest rates on their deposits and lower interest rates on loans and also build-up their capital. By 2004, these banks had a share of over 40 per cent of the total microfinance market in the country. In Indonesia, a study of the banking sector post the East Asian Crisis showed that 77 largely private small banks that were an important source of small business lending were profitable and had a return on assets that was higher than that for the banking system as a whole.

In the US, there is evidence of a strong negative correlation between the ability to lend to smaller entities and bank size (see Berger et al. [2005]). A large number of small, community-focused, banks co-exist with large money centre banks, primarily be-cause they provide relationship loans within the community. The US data shows that small businesses with local banking relationships received loans at lower rates and fewer collateral requirements, had less dependence on trade credit, enjoyed greater credit availability, and protection against the interest rate cycle than other small businesses (see Petersen and Rajan [1994]).

In the UK, the Treasury Committee of the House of Commons noted that localized forms were better able to target financially excluded who tend to have geographic concentrations. New innovations in financial inclusion strategies have often come from credit unions, community banks and non-profit banking institutions (House of Commons, 2006).

A number of dynamic local financial institutions with a good track record of reaching the poor currently exist in India. Many of these are MFIs, with a client base that largely consists of the poor. These institutions are small, yet well performing, and are undertaking a fair amount of innovation in increasing financial services to the poor. They are constrained in that they cannot offer a full range of financial products to their clients, especially deposits which would also allow them to lower their cost of funds (and commensurately their lending rates). This results in a situation where MFIs cannot reach critical mass, in terms of asset size or profitability, to be able to finance investments in core banking solutions, HR etc. These MFIs are too small to apply for an SCB banking license, which would require a capital base of Rs. 300 crore. As of March 2007, the total equity base of all the 54 Indian MFIs put together was a shade below the Rs. 300 crore capital requirements. Even among the top 15 MFIs, it would take anywhere between 5 years to 15 years to grow their asset and equity base to meet the minimum criteria to be a bank. Given the current interest in microfinance, raising equity capital is a possibility for expansion, but this would require promoters to significantly dilute their stake in the MFI, with attendant loss of incentives and governance. Some of these well-performing MFIs would benefit from transforming into small finance banks.

The Committee recommends, therefore that the regulator allow more small finance banks to be established, with the ability to provide both asset and liability products to their clients. One rationale for these banks would be to increase financial inclusion by reaching out to poorer households and local small and medium enterprises. But these banks should not be constrained to only these clients. As we argue in Chapter 4, these banks could also be an important entry point into the banking system from which some banks could grow into large banks. We suggest the following features:

1. Having obtained the permission to start up based on an initial business plan, small banks should have some leeway to decide where they will grow and what they will focus on, much as we advocate for large banks (see Chapter 4), conditional on meeting regulatory requirements and obligations. Given, for example, that the poor will increasingly be concentrated in towns and cities, and given they are underserved there, we do not see any reason to limit small bank locations to only rural areas.
2. However, given that we are recommending unlimited branching for banks elsewhere, it would be appropriate to restrict the initial license to a certain maximum number of branches and asset size, with these restrictions removed after a review of performance.
3. These banks would provide a comprehensive suite of financial services (credit, savings, insurance, remittances, and investments). To facilitate appropriate diversification and smaller loan ticket sizes, their exposure limits would be set at a lower fraction of capital than for SCBs, allowing them to increase ticket sizes as they grow.[28] They would also be expected to provide mainstream-banking products, thus precluding, for example, the need for a large treasury operation or other activities that require very sophisticated human capital or management.[29]
4. Interest rates on loans would be deregulated, as is the case for Local Area Banks (LABs). Initial total required capital should be kept at a low level, consistent with the initial intent behind LABs. However, the focus should be on a number of performance measures, such as (*i*) the capital adequacy ratio, which could be

more conservative for small banks given that they typically operate in smaller geographies and lend to riskier businesses; (*ii*) the ownership structure (for private banks) ensuring appropriate incentives; (*iii*) governance norms, fit and proper criteria; (*iv*) the adoption of a core banking solution, which could be developed in-house for larger entities or purchased from a specialized provider for smaller entities; (*v*) the track record of the promoters and (*vi*) strict prohibitions on self-lending to promoters and directors.

5. These banks would require greater monitoring and would likely increase the supervisory burden on the regulator, especially in the beginning. In the initial years after the inception of a small bank, the banking supervisor should conduct more off-site and on-site inspections (perhaps quarterly as with the LAB proposal), bringing them down as confidence is established in the bank's procedures. Off-site supervision could be via standardized uniform back-office processes and computerization through a common platform. Strict prompt corrective action norms should be applied after the initial teething years (see Chapter 6) so that unviable banks, and there will be unviable banks, are not continued. The Committee understands that regulatory capacity will have to be increased (certainly, for example, the number of bank supervisors). But regulatory capacity should adapt to the needs of the banking system rather than vice versa.
6. The government should encourage the creation of low cost technological platforms that can be offered widely to small banks. Small banks may also be encouraged to pool back-office functions, and even a centralized skill base, along the lines of models that exist in other countries.[30]

With the creation of a small bank category, current institutions that operate at a local level—MFIs, community-based lending organizations, etc.—would have the choice of deciding their institutional structures. Those that would like to remain purely credit-based institutions can choose to remain as NBFCs—as most MFIs today are—or Section 25 companies. Others could choose to provide savings facilities as limited business correspondents of large banks (see below).

Still others that have established a good track record of banking and wish to raise their own deposits could choose to become small finance banks with a capital base which would, in effect be well below the current Rs. 300 crore for SCBs. These institutions' financial health would be monitored using risk ratios, governance and management standards that attest to their financial soundness. As these banks grow and achieve scale, they could be permitted to become full-fledged SCBs. The regulator would need to further think through the ownership issues related to the transition between small banks and SCBs. While at inception a small bank could be majority owned by a single promoter, as it scales up and approaches the size of an SCB (i.e., gets closer to a capital base of Rs. 300 crore) it would be governed by ownership norms currently applicable to SCBs, and it is expected that promoters would dilute their shareholding to that applicable to SCBs.

We see four important merits in the proposal for small finance banks. First, a full range of institutional options will become available to a spectrum of players who are important for an inclusive finance marketplace. Second, a point of entry will be established into the banking system, increasing competition, especially for small customers. Third, this flexibility would be enabled in a manner that preserves the stability of the overall financial system, an important consideration for the regulator. Fourth, the clarity that emerges from the small finance bank structure will remove the regulatory uncertainty that many MFIs currently operate under and release management time to focus on the clients of these organizations, and also increase risk appetite and innovation in these institutions.

A clear articulation of the regulatory and organizational options to service poor clients will help do away with many lingering issues plaguing institutions operating in the 'inclusive finance' space. For example, small finance banks would be required, by virtue of their 'bank' status, to disclose the effective interest rate charged including loan processing fees, bad debt provisions and other ancillary charges. The focus on transparency, reporting standards and codes of conduct should also be carried through to the rest of the financial institutions—NBFCs, MFIs, etc.

The second channel to create an inclusive financial architecture is to create strong linkages between large institutions and local entities to bring the existing large banks closer to the poor. This is certainly the trend to reach the poor, as evidenced by the increasing use of credit-scoring and technology by large banks to reach remote areas. To facilitate this, in India, the business correspondent legislation is particularly laudable given its good potential for combining the scale economies and diversification that large banks bring with the local knowledge and low cost outreach provided by business correspondents.[31] However, recently announced regulations, such as one stipulating the presence of a bank branch within 15 km of its business correspondent in rural areas, vitiates the objective of low cost outreach.

A central difficulty in using business correspondents is the extent of responsibility the bank should bear for the processes and actions of the correspondent. While it seems clear that the bank should be responsible for actions undertaken by the agent on its behalf, requiring the same standards and processes at the agent as the bank would negate the potential benefits of a correspondent model. The true test is whether the standards and processes are adequate for the business the correspondent is required to do. So long as the bank exercises due diligence and is responsible for outcomes, a fair amount of flexibility should be allowed in the relationship. The Committee recommends that the BC definition be broadened and endorses the recommendations of the Rangarajan Committee on Financial Inclusion with regard to the BC model. It supports the proposal to allow microfinance NBFCs to act as limited BCs for banks for savings and remittances products and recommends that microfinance NBFCs also be allowed to provide credit as BCs of banks if they choose to do so.[32] Finally, in order to make this business viable, it is important that business correspondents be allowed to levy reasonable user charges to recover the cost of services. Competition, as well as mechanisms for consumer protection, rather than regulation, should be the means through which the regulator ensures business correspondent charges are not excessive.

Given the reality that moneylenders will always perform the much-needed function of providing residual credit to the poor, rather than prohibit them or levy unenforceable interest caps, it may be prudent to explore ways in which moneylenders and banks may work together. The Committee endorses the model legislation recommended by the RBI Technical Group to Review Legislations on Money Lending, 2007 as a good step towards providing a single regulatory framework for money lending.[33]

Finally, the Committee recommends that the regulator actively explore the channels by which non-traditional entities with extensive low cost networks (e.g., post offices), regular contact with the underserved (e.g., kirana shops, cell phone companies) or with some leverage over potential borrowers (e.g., buyers of produce, sellers of inputs such as fertilizers) could be used to provide financial services in a viable manner.[34] While the business correspondent model will be one way these entities can link up to the formal financial system, the larger question, however, will be whether some non-traditional entities can directly and independently provide regulated financial services. For instance, should cell phone companies be able to offer account-to-account transfers without going through bank deposit accounts? The answer to these questions should be based on what is the most efficient way to provide services while imposing tolerable levels of systemic risk. Some of the new non-traditional players may be large and well capitalized (e.g., cell phone companies), and may therefore add less risk to the system than the existing reliance on some financial entities. However, the more such players are allowed to take part in payments, the more extraneous obligations on the banking system will have to be brought down so that banks can compete on a level playing field (see Chapter 4).

More generally though, given the importance of expanding inclusion, a greater tolerance for risk is warranted, and more entities should carefully be allowed into regulated activities. Box 2 highlights some guiding principles that could help regulators identify the key features of a regulatory and supervisory framework that could underpin branchless banking.

A focus on risk mitigation

Perhaps the greatest challenge to financial inclusion is to design efficient risk management products for the poor. The poor are typically exposed to a level of risk that is too high for them to obtain insurance at affordable rates. Thus the levels of risk may have to be first brought down through physical methods—soil and water conservation for reducing drought risk in case of crop insurance; herd vaccination in case of livestock insurance; and preventative health care, safe drinking water and sanitation, in case of health insurance. A key policy implication therefore is to increase investments that lead to intrinsic risk reduction so that insurance can be offered at premia that minimize the need for subsidies. Once this is done, it will be useful to use public funds to build awareness about insurance as a critical financial service, since greater demand for insurance can bring down costs due to scale economies.

A number of specific policy initiatives can help develop microinsurance products that

Box 2: Regulating Branchless Banking: Key Considerations

Branchless banking has emerged as an important medium to increase financial inclusion in a cost-effective manner. The two models currently used include the bank-based model where customers transact with an agent of a prudentially licensed and supervised financial institution, and the non-bank based model where deposits are taken by and cash is exchanged with a retail agent not affiliated to a bank, such as mobile operator or an issuer of store value cards. The virtual account is stored on the server of this non-bank entity. Branchless banking has been especially useful in providing remittance and payments services.

The Philippines and Kenya have achieved some degree of success with the non-bank model. In the Philippines, both major telecom operators, Globe and Smart, offer mobile financial services to over 4 million users. In Kenya, Safaricom's M-PESA service also focuses on getting domestic and international remittances to remote parts of Kenya using a POS device that captures client details in a smart card. Brazil and South Africa have chosen bank-based models to mitigate risks associated with the non-bank model. In Brazil, Caixa Economica is a bank that uses a range of retail outlets (grocery stores, lottery shops, etc.) as business correspondents to provide banking services, the most popular being payment services. The two models can also be used in combination. For example, Philippines' Globe Telecoms has teamed up with member banks of the Rural Bankers' Association of the Philippines to offer its clients the ability to effect loans payments, deposits, withdrawals and transfers from savings bank accounts from these banks by sending a text message. Recently, Pakistan released draft guidelines for branchless banking and has endorsed the bank-led model either via the bank-agency arrangement or creating joint ventures with telecom/non-banks.

The experience so far with both models is limited and it is difficult to draw clear lessons about which model may be superior. The risk issues related to the non-bank model are far from trivial, though not insurmountable, as the Philippines and Kenyan examples show. Going forward, a number of guiding principles are useful for policymakers to consider as countries adopt the model most viable for them. These are highlighted below:

- First, it is imperative to enact regulation that takes care of issues related to compliance with anti-money laundering and combating the financing of terrorism (AML/CFT) guidelines. This is well understood globally, and explains why some countries have chosen bank-linked models for branchless banking. Compliance issues should not rule out the viability of non-bank models; however it is difficult today to point to a non-bank model that seems to achieve full compliance with AML/CFT issues.
- Second, regulators should set clear guidelines for technology use, security of customer data and standards for messaging (in the case of mobiles). This should be complemented by a robust mechanism for consumer protection that is well communicated to consumers.
- Third, implementation of branchless banking should be closely monitored in order to provide policymakers/regulators relevant, recent and reliable data about the progress of various initiatives.
- Fourth, the regulator should clarify the legal power of non-bank retail outlets and clearly specify restrictions (if any) on the range of permissible agents and types of relationship.
- Fifth, and perhaps most important, regulators should strive to achieve complete interoperability between banks, telecom companies, and other branchless banking entities in the medium term. This is crucial to ensure value added from branchless banking to the consumer. A good analogy is the text message market, which ballooned only after users could send text messages to persons even if the recipient subscribed to a different telecom provider. This would involve a number of steps, including uniform KYC requirements, the ability of RTGS to handle branchless banking transactions, and other issues that are just beginning to be understood as branchless banking gathers steam.

The success of branchless banking will depend greatly on the ability of different regulators and agencies responsible for banking, telecom, and anti-money laundering to ensure an outcome that is truly value added to the consumer and can radically transform the way financial transactions are conducted.

Sources: CGAP, Regulating Transformational Branchless Banking: Mobile Phones and other Technology to Increase Access to Finance.

are critical for the poor. Among the most important are actions that would increase awareness about the benefits of insurance and communicate the provision of government insurance more transparently to the insured population. A number of central and state government insurance programmes are currently offered through insurance companies, however, awareness about these schemes is minimal as indicated by the fact that claims ratios on them are far below actuarial expectations.[35] This leads to short run profits for insurance companies but no benefits to the poor. User fees are also critical to ensure ownership of insurance by the insured. A number of public insurance programmes have required no premia contribution on part of the insured. A 'symbolic' premium would go a long way to increase awareness about the insurance plan as well as increase usage. The government should also conduct negative auctions, where an insurance company asking for the least amount of subsidy for a specified level of coverage of a target group, should be given the mandate to do so and collect the premia.

A second set of issues relates to deregulation of premia. IRDA microinsurance guidelines should eliminate caps on premia and commissions, and allow for-profit entities to be microinsurance agents. The argument here is analogous to the interest rate deregulation argument. To cover a large number of the poor, pricing must be left free so that over a period of time many players will enter and reduce costs through competition. The counterpart of free pricing has to be greater transparency about all-in costs, as well as public disclosure of premia. Similarly, in addition to NGOs and SHGs, NBFCs and banks as well as non-traditional outlets should be allowed to distribute microinsurance.

Health insurance for the poor, and particularly for women, needs to be designed with a high priority. For this, the IRDA should facilitate the creation of health insurance mutuals, friendly local entities that function as the interface between the client and the insurance company.[36] These 'mutuals' would require adequate reinsurance cover against large covariant risks and 'long-tail' claims to ensure that they remain solvent in the event of large covariant adverse events such as an epidemic or a few expensive claims.

Customer service issues in terms of claim processing delays and deductions need to be monitored tightly and penalties enforced on erring companies. The Office of the Financial Services Ombudsman needs to be set up quickly (see Chapter 6), with close ties to the IRDA.

Finally, a number of policy actions are required to deal with the insurance needs of agriculture. The link between crop credit and crop insurance, though mandatory, should be made more effective and benefit more farmers. The National Agricultural Insurance Scheme should be reengineered to ensure timely claim settlement by improving the crop cutting experiments or using remote sensing data. Weather index insurance products could enhance NAIS, for example, through advance, part indemnity payments during the crop cycle based on weather indices, with final settlement based on the area yield assessment. This could represent a cost-effective combination of the best features of both area-yield and weather-based insurance and could be introduced as part of the proposed modifications to NAIS. Further, weather indexed products could continue to have a separate existence as standalone products, thereby, giving farmers choice in selecting risk mitigation measures. However, weather index insurance is mainly effective for select hazards like deficient and excess rainfall, and not for all perils and hence needs to be used judiciously. Lastly, where weather insurance is offered as a standalone product, government's role in fostering a level playing field for all providers of weather insurance would be critical in stimulating competition, innovation and providing benefits to farmers through better product features and services. An increase in post-harvest credit, which would in turn be greatly facilitated if warehouse receipts could be issued, can reduce price risks for small farmers. This requires building a network of credible ware-house agents, including assayers and the quick implementation of the Warehousing Regulation and Development Authority Bill.

Though India has three major and several smaller modern commodity futures exchanges with billions of dollars of transactions on a daily basis, small farmers are not able to benefit from these. This is because the key functions—quantity aggregation and price assessment (based on quality)—are currently played by *ahratiyas* (traditional commodity brokers), who often collude to make lower payments to small farmers. To ensure that *ahratiyas* do not exploit farmers, apart from wide dissemination of price information, which is happening already, farmers need the ability to sell to a processor right from the village (as is currently happening with ITC *e-Choupals*) if they find the price attractive.

Alternately, farmers bringing their produce to a *mandi*, but not finding the price attractive, should be able to sell to another distant *mandi*. This is being enabled by the new generation of 'spot' exchanges like NCDEX Spot Exchange Ltd (NSEL) and SAFAL National Exchange (SNX) but requires a network of reliable warehousing and assaying agents. It is important to support these legitimate functions and let banks finance them, so as to encourage the emergence of this commodity marketing ecosystem. Once again the implementation of the Warehousing Regulation and Development Authority Bill expeditiously will help.

Rethink targets, subsidies, and public goods

While a new, more market friendly approach is advocated, the role of public intervention must change to focus more closely on the excluded. Important policy actions are required in the following areas:

1. Priority sector lending framework
   The priority sector lending framework has historically had at least two, not mutually exclusive, objectives. One is to channel resources to areas that were deemed national priorities, and the other is to foster inclusion. The value of a developed financial sector is precisely to allocate resources to areas that are most valuable for the economy. By designating national priorities, the government or central bank vitiates this process by imposing political or personal judgements on what should be strictly a market driven, economic process. Why, for instance, are loans of up to Rs. 20 lakhs to students for undergraduate studies abroad deemed priority sector? The reality is that priority sector norms were set historically, at a time when the financial sector and the economy, were very different. Many Committees proposed a reduction in the level of directed lending through the priority sector for a number of reasons, but this suggestion was not implemented.[37] There appear to be very strong political constraints on revising these norms downwards. As a result, regulators have taken the next best option of broadening the categories that qualify for the priority sector.

   This Committee understands the imperative behind such actions, but strongly recommends the political will be found to revisit the norms. Failing that, it suggests the categories that truly impact the underserved (such as direct agriculture and the weaker sections category) be preserved and strictly enforced even as the process of broadening other categories continues. Keeping in view the growing importance of rural to urban migration, and the growing share of the urban poor, consideration should be given to including them in the overall agricultural share. The Committee further recommends certain steps below that would increase the flow of credit to these underserved segments as well as facilitate the provision of priority credit by specialized financial institutions that are better placed to provide it.

   The Committee recommends that all banks—domestic and foreign—should be subject to uniform priority sector lending requirements. In the interest of equitable treatment, and given the magnitude of need to provide credit to underserved segments, it is not clear why a differentiated framework should exist for foreign banks. Foreign banks do not have the branch infrastructure to provide agricultural credit, but free branching (see Chapter 4) will give them the capacity to undertake such loans if they desire. Moreover, the Priority Sector Lending Certificate scheme (see below) will help them bear their share of obligations without a branch network.

The RBI has proposed a scheme, which with a few modifications could prove very attractive in facilitating flows to the priority sector. The inter-bank participation certificates (IBPC) are a form of securitization of loans through which a bank buys the assets of another bank for a stipulated period that can vary between 90 and 180 days. The RBI allows a bank that is unable to meet the priority target of 40 per cent to make up the deficit by buying out loans disbursed by other banks for 180 days.

One problem in any securitization is that the buyer has to take on the credit risk of the loans, which is high in the case of the underserved priority sector. Moreover, loans have to be standardized, well documented, and serviced, all of which pose difficulties for loans to the truly needy. Perhaps this explains why the scheme has yet to take off. The Committee proposes a new scheme that will separate the objective of transferring priority obligations from the credit risk transfer and refinancing aspects, which are commingled in the IBPC.

New PSLC Scheme. Here is how the scheme would work. Any registered lender (e.g., MFIs, NBFCs, co-operatives, and eventually, registered moneylenders) who has made loans to eligible categories would get 'Priority Sector Lending Certificates' (PSLC) for the amount of these loans. The criteria for certification (say by NABARD or its agents) would simply be whether the loan is to an eligible sector, whether the interest rate follows the norms below including transparency, and whether the loan duration is greater than 180 days. After an initial period of verification, institutions should be allowed to self-certify, with periodic random monitoring to ensure adherence to criteria. Any bank that exceed priority sector norms should also receive PSLCs based on the amount by which the requirement is exceeded.

A market would then be opened up for these certificates, along the lines of the IBPC, where deficient banks can buy certificates to compensate for their shortfall in lending. Importantly, the loans would still be on the books of the original lender, and the deficient bank would only be buying a right to undershoot its priority sector-lending requirement by the amount of the certificate. If the loans default, for example, no loss would be borne by the certificate buyer. The certificates would foster the creation of small financial institutions that specialize in priority sector lending, much like the impact of the US Community Reinvestment Act on Community Development Financial Institutions (Box 3).

The IBPC scheme could continue, but would not qualify for priority sector norm—it would be simply a form of securitization and refinance. Of course, the seller could also transfer its associated PSLC certificates if it so chooses.

While all PSLCs could be used towards meeting overall norms, separate certificates could be issued for enforceable sub categories (e.g., direct agricultural credit), and these may carry a different price. If indeed banks

Box 3: The US Community Reinvestment Act and Its Impact on Financial Inclusion

The Community Reinvestment Act (CRA) was enacted in 1977 with the objective of getting mainstream financial institutions in the USA to increase provision of credit to low and middle-income communities. While there is much debate about CRA's effectiveness in achieving financial inclusion in the USA, an important benefit of the legislation—unanticipated at the time of its enactment—was its success in fostering the growth of specialized Community Development Financial Institutions (CDFI) that were instrumental in expanding financial services to low-income communities. CDFIs include banks, loan funds, credit unions—financing entities with the primary mission of serving underserved or economically distressed areas. In 1995 CRA reforms allowed banks to comply with the CRA by making loans to and investments in CDFIs. Since then, CDFIs have come to rely significantly on CRA qualified investments and loans from banking institutions as a major source of funding for their activities. A bank may receive two benefits from investments in CDFIs; first it receives CRA credit, and second it can apply for financial awards from the CDFI fund. The customer base of CDFIs is 68 per cent low income and 58 per cent minority in the US. Reports show that CDFIs significantly outperform regular banks in serving low income and minority communities.

The US experience shows that big banks' response to CRA type of regulations can be significantly enhanced by coupling the need to meet the mandate with creating dedicated entities like CDFIs, which can use CRA credits to serve the under-served market segments. In the Indian context, this experience suggests that priority sector lending could enhance financial inclusion if the lending requirements are coupled with incentives to create specialized financial institutions that can lend successfully to underserved segments in India. Specialized institutions can cultivate the local knowledge needed to reach informationally opaque markets and can develop uniquely tailored underwriting and risk management procedures as needed. Specialized knowledge coupled with specifically tailored and flexible operations are often necessary to reach under-served market segments. However, while the promotion of specialized institutions is highly desirable, established financial institutions should still be encouraged to directly serve these under-served market segments.

Source: 'The Community Reinvestment Act and Financial Inclusion', Yale Law School Community Development Financial Institutions Clinic, 2008.

find priority sector requirements unprofitable, there will be a high price for these certificates, and it will draw more lenders (including banks that want to specialize) into priority-sector lending. If the price is low or zero after the market is given time to stabilize, it would mean that priority sector requirements, as set, are not onerous.

However, this market also offers the government a way to expand lending—all it needs to do is purchase eligibility certificates and increase their price. Charities and NGOs that want to contribute to inclusion could also buy in this market. Also, over time, as bank privileges diminish, the priority sector requirements for banks should be brought down, with the government playing a larger role in purchasing certificates. The government could establish a predictable pattern of activity in this market (for instance, by stabilizing the price of certificates or by specifying its target volume of purchases) so that potential lenders have greater certainty about the rewards from lending.

The market would make explicit the subsidy to the priority sector (effectively the price of PSLCs), and allow the government to gradually take over the role of providing these subsidies from the banks in a minimally distortionary and disruptive way. While, a priori, this market may seem complicated to manage, there are really no additional complications than in managing say the market for bank reserves, which is easily accomplished across the world.

2. Interest Rates
   Finally, it would also be necessary to deregulate interest rates in order to unlock funds to activities that are commercially unviable and therefore denied credit (Box 4). Current priority sector norms—especially those focused on lending to the poor (loans below Rs 2 lakhs)—have interest rate ceilings that make lending

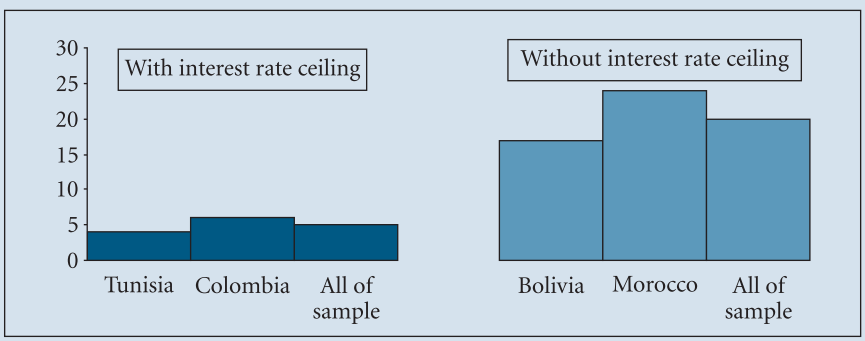
Box 4: Interest Rate Ceilings Hurt the Poor

A study by the Consultative Group to Assist the Poorest (CGAP) examined the impact of interest rate ceilings on microcredit penetration in 30 countries and found that on balance, interest rate ceilings deterred expansion of microcredit to higher-cost markets.

The study compared market penetration rates between 23 countries with interest rate ceilings and seven countries without ceilings. On average, the former had a market penetration of 4.6 per cent, whereas countries without interest rate ceilings enjoyed penetration rates of 20.2 per cent. In countries without ceilings, the study found that competition was an important force in bringing down interest rates. For instance, the microfinance portfolio yield* decreased from an average of 57 per cent in 1997 to 31 per cent in 2002 in four competitive markets without interest rate caps (Bolivia†, Bosnia, Cambodia and Nicaragua). Operating efficiency (defined as total administrative costs as a percentage of the average loan portfolio) improved during the period from 38 per cent to 24 per cent. The study cited specific examples of the impact of interest rate ceilings on microcredit expansion. In Nicaragua the market for microcredit shrunk after the national Parliament introduced an interest rate ceiling on microfinance institutions (MFIs) in 2001. The annual growth of portfolio of these MFIs fell from 30 per cent to less than 2 per cent post the imposition of the interest rate ceiling. In Kenya, the threat of a new interest rate-ceiling bill caused the Cooperative Bank of Kenya to put its plans for a major expansion into the rural microfinance market on hold.

In India, allowing MFIs and SHGs to charge market-determined rates from final borrowers has facilitated a significant expansion of microcredit. In sectors where interest rate ceilings exist, such as agricultural loans in the priority sector below Rs. 2 lakh to farmers, and such credit could not be provided via the MFI/SHG route, credit provision grew at a slow pace.

Microfinance Market Penetration in Countries with and without Interest Rate Ceilings, 2004



Source: CGAP, Occasional Paper No. 9, 'Interest Rate Ceilings and Microfinance, The Story So Far', September 2004.

Note: Number of microfinance borrowers shown as percentage of population living on less than US$2 per day. Sources: Calculations for 23 countries with interest rate ceilings and seven countries without ceilings based on Christen et al., *Financial Institutions with a 'Double Bottom Line',* and World Bank.

Notes: * Portfolio yield is defined as the ratio of income from lending to average outstanding loan portfolio. Income used to calculate yield includes all cash interest and fee payments, but does not include interest accruals.

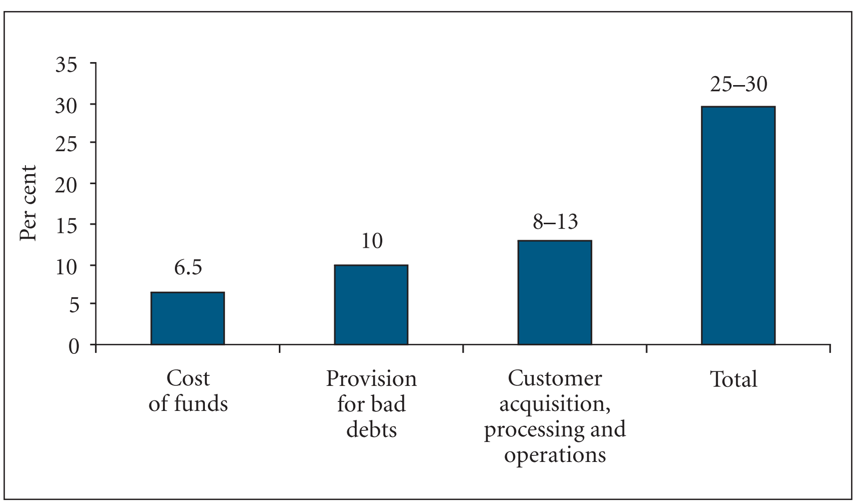
† Introduced ceiling in January 2004.

unattractive for the banks. In general, the true cost of small loans is very high (Figure 9). This is also reflected in the interest rates currently paid by the poorest borrowers, which is typically in the range of 36 per cent plus per annum.

The approach thus far has been to deregulate interest rates for certain activities in order to stimulate credit provision. For example, in 2000, RBI deregulated the interest rates on loans made by commercial banks to MFIs, and interest rates on loans made by MFIs to borrowers. Again in 2006, RBI emphasized that the interest rates applicable to loans given by banks to MFIs or by MFIs to SHGs/member beneficiary would be left to their discretion. This leads to an anomalous situation where loans to the same beneficiaries if dispensed through alternate channels of financing are priced differently. Indeed, these regulatory anomalies suggest yet another reason for avoiding interest rate ceilings—it tilts the playing field against the formal sector where such ceilings will be respected in favour of the informal sector, where they are much harder to enforce.

A related issue is the implementation of usury laws. While the Committee recognizes the value of usury laws to protect against unscrupulous lenders, the reality is that these laws are difficult to enforce, and are often misused. The Committee recommends that all financial institutions licensed and registered with the RBI or enacted under special state government statutes should be automatically exempt from usury laws.

Figure 9: True Cost of Lending for Banks for Small Ticket Loans



Source: ICICI Bank Staff Estimates (for cost of funds) and Boston Consulting Group (2007), *The Next Billion Consumers: A Road Map for Expanding Financial Inclusion in India* (for other costs).

The Committee recognizes that weaker sections are liable to exploitation. But driving them away from banks via interest rate ceilings into the hands of moneylenders is no solution. Instead, it proposes the following safeguards. A liberalized interest rate regime should be accompanied by a transparent way of communicating to borrowers up front what the all-in cost of a loan will be (a simple number which reflects the effective interest rate they are being charged when all fees are included), public disclosure of margins on loans to the priority sector relative to reasonable cost benchmarks,[38] and an effective system for tackling consumer grievances (see the financial ombudsman proposed in Chapter 6). However, the most important check will be that loans with interest rates that meet a 'reasonable margin' test imposed by the regulator based on prevailing costs will get priority sector lending certificates, which they can sell for an extra margin.

3. Subsidies and public goods

The Committee believes that well-targeted subsidies provided directly to the poor are a more useful option than subsidies to financial entities for provision of services. Notwithstanding this belief, there is still a case for the provision of subsidies for services in remote areas or to target underserved segments. A minimum set of services could be specified, which would satisfy the needs of a poor family (e.g., offering micro payments and micro savings) or standards set for an entire underserved area. The standards could be set in such a way as not to preclude innovative ways of offering them, including through technology. The service obligations in areas that are considered financially excluded could then be auctioned off, with (typically) negative bids indicating subsidies the government would have to offer. The subsidies could be set on a per account or a per area serviced basis. The hope is that such subsidies would be short term, with their need eliminated as these areas and segments exhibit signs of commercial viability.

An alternative would be to have those who provide financial services in underserved areas obtain certificates based on creating accounts or other services in underserved areas, and allow these certificates to be traded, much like the PSLC.

Instead of banks being obligated to open rural branches, they could incur a service obligation based on the number of accounts they have of the better off in urban areas (see Chapter 4). They would initially support the market for the certificates.

Another useful step would be to provide existing subsidies and cash transfers to the poor via bank accounts to encourage their use of the banking infrastructure. Recipients of payments from various anti-poverty schemes (SGSY, NREGS, etc.) as well as microinsurance and old age pension schemes could be asked to open no-frills bank accounts augmented by biometric cards (which will help reduce multiple or *benami* IDs and, hence, corruption). Payments could be channelled to these 'household development' accounts via a monthly cash transfer that is electronically swept into the account (rather than the current lump-sum transfer which is a large portion of the household's assets and is often misused). The precise modalities for these products will have to be worked out but channelling them in this way will help greatly in organizing payments from various existing schemes in a manner that the poor can get maximum leverage from the resources they receive.[39] The pattern of their usage of these funds will also help them build savings histories that can be the basis of formal credit later on.

Public intervention may be needed to promote simple low-fee savings instruments that are indexed to the stock market and available for purchase in small units by small investors, savings funds, etc. This would allow small investors to tap into the large gains that equity market investors have enjoyed the world over in recent times. It would also allow them a better savings instrument than savings accounts that have given them miserable real returns in the past. Currently, the lack of PAN numbers among the poor prevents the wider dissemination of such products. There may be a case to subsidize the provision of PAN numbers for poor clients who wish to participate in this scheme.

The government could also provide for (by arranging or paying for, not necessarily undertaking the function itself) common services that could help achieve scale and reduce the costs of financial intermediaries in providing financial services. For example, in Mexico, BANSEFI (National Savings and Financial Services Bank) provided centralized back-office services like electronic transfers, liquidity management, clearing house services, debit and credit card services, and foreign exchange and derivatives transactions to enable financial institutions scale up financial services to low-income households.

Mexico also offers other examples of innovative provision of public goods to facilitate financial inclusion that might be worth replicating in India. One is the securitization of trade credit through NAFIN, a Mexican development bank that has created an electronic system to facilitate this activity (see Chapter 7). A second example is that of FIRA, a Mexican development financial institution that provides increased finance to agriculture sector using structured finance transactions.

Use technology to reduce cost of delivery

A recent Boston Consulting Group report estimates that the cost of funds today is 9 per cent, provision for bad debts is 10 per cent and cost of consumer acquisition and transaction and operation cost is 13 per cent for the poorest customers, leading to banking for the poor becoming unprofitable.[40] The key role that technology has to play is to reduce the last two components drastically. Reducing these costs can translate into lower lending costs, which would help improve the viability of risky rural businesses and allay concerns that the high cost of lending to poorer segments is resulting in over-indebtedness. Equally, distances are large in rural areas and transport sparse. Here again, communications technology could play an important role by bridging the last miles between the customer and the provider and thus facilitating transactions.

Transaction and operation costs consist of front-end costs, network costs and back-end operation costs. Back-end costs for banks vary from Re 1 to 2 per transaction. Indian mobile companies however, have managed to reduce backend costs (for what are essentially similar operations to between 1 and 2 paise per transaction. While banks have done a good job in computerizing their operations, they need to learn from mobile operators and optimize back-end technologies and leverage volume to significantly reduce these costs.

The telecom network in India is rapidly evolving. The banks need to move towards leveraging this network and design their networks afresh to expand operations, reduce costs and increase reliability of their operations.

The front-end continues to be the dominant costs for banks. The use of ATMs has significantly reduced front end costs but they are still too high. Banks need to promote lower costs indigenous ATM technologies, especially for rural areas. Going beyond ATMs, front-end costs can be brought to negligible amounts by replacing cash transactions with electronic transactions. More than 80 per cent of India's financial transactions are processed in physical cash. Cash as means of payment has a large cost in terms of handling, transaction processing, holding and risk of loss. On the other hand, Internet banking transactions have zero front-end cost for the banks; efforts have to be made to make this a preferred mode of transactions for large corporations. Its extension to SMEs may have much larger impact. Rural Internet Kiosks can be used by all rural businesses to carry out such transactions.

Mobile banking is perhaps the most promising front-end technology for facilitating financial inclusion in India, especially for individual customers. Given the success of mobile phones in reaching out to segments and geographies not yet penetrated by banking and the simplicity of their operation, this may be one of the more preferred interface of choice for most banking clients. The telecom and the banking industry along with RBI has recently constituted a Mobile Payment Forum of India (MPFI) to examine technological, regulatory and business constraints related to the scaling up of mobile banking in India (Box 4). This Forum's recommendations would be the key to provide a roadmap for mobile banking. Additionally, Stored Value Cards would be another important vehicle for financial inclusion.

There is a need to create common payments systems with participation by multiple banks, to reduce transaction costs and substantially increase the deployment and utilization of POS terminals. An important advantage of all these interfaces is that they are essentially cash-less and minimize fraud and the costs related to cash handling.

Further, technology can be significantly leveraged for acquiring customers. Banking correspondents (BC) with Internet Kiosks at villages as well as BCs armed with mobile phones with back-end interface (e.g., the kirana shop) has to be used extensively. A unique ID for each citizen would help accelerate this.

Finally technology has to be used to reduce provisions for bad debt. Credit ratings for retail customers and a unique citizen ID are critical in this regard. Capturing all the transactions electronically and mandatory sharing of data with a credit bureau would significantly help in this direction (see Chapter 7). The absence of this and high provision for bad debts, is in fact hurting the poorest most.

The role of public policy is to enable the adoption and scale up of appropriate technologies while mitigating risks of their misuse. Public policy can play an important role in the establishment of a unique identification number and the promotion of biometric authentication, which would facilitate the development of credit bureaus (see Chapter 7). As mobile banking becomes widely prevalent, it may be worthwhile to map a citizen's unique ID to his/her phone number. Low cost ATMs will also play a major role in financial inclusion. Further development of real time inter-bank transactions would be essential for mobile banking to take off. To make mobile banking profitable, the costs of this system need to be very low. While the RBI in consultation with IDRBT can initiate a common payments platform, it would be useful to encourage private initiatives in this area in order to foster innovation and drive down costs. KYC norms should be made common for banking, telecom and insurance.

Government funds could be used to promote the use of technology among the poorest clients and small financial service providers. The Rs. 500 crore Financial Inclusion Technology Fund, proposed by the Rangarajan Committee on Financial Inclusion and announced in the 2007 Budget speech, could be used to finance the creation of common technology platforms or back office services for small financial services providers who are serving the poorest clients. It could also be used to promote mobile payments amongst the poor.

The most important way to figure out the appropriate technology would be through careful experiments. Many experiments are required. Many of these experiments would fail. But results from these experiments would help us get the answers. To the extent there is a role for the government apart from helping coordinate the setting of standards, it would be to fund experimentation in areas where there is a significant public goods component (such as payments).

An ambitious goal can serve to bring all these considerations together. The Committee believes that with some effort, 90 per cent of Indians can have access to the formal financial system, at the minimum through a 'no-frills' bank account if they so desire, and advocates that this goal be achieved in three years.[41] These accounts would be especially useful for households with migrant workers to receive remittances as well as for low-income households to receive cash trans-fers from NREGS and other programmes. As discussed in previous section under point 3 'Subsidies and public goods', providing such payments through bank accounts minimizes the logistical challenges associated with providing cash as well as the incidence of leakage.

In this regard, the Committee recommends the creation of a nationwide electronic financial inclusion system (NEFIS) that would link these bank accounts and allow funds to be transferred into them electronically. Such mechanisms can present a saving to the government, both in terms of administrative burden and in terms of cost. The cost per beneficiary of this infrastructure is largely a function of volumes. Fixed costs of the POS/mobile devices, computer servers and incremental communication networks to service about 50 crore un-served citizens would be around Rs. 1,000 crore. The variable costs are relatively small; if smart cards were used, the variable cost per user would be less than Rs. 40, while putting biometric capability on a user's cell phone would cost less. The cost per transaction of NEFIS could drop to a few paisas, as millions of outlets accept e-payments. Of course, for cash-in/cash-out transactions, requiring a human/machine interface, the cost per transaction could be as higher.

Once NEFIS is in place, it would enable transactions as small as Re 1 to be carried out with limited transaction costs, as long as these are cashless (indeed millions of these are being done and recorded, as in case of cell phone calls and SMS-es which are charged). If cash was to be out in or taken out, transactions as small as Rs. 100 could be

M–Banking Solutions for India

Mobile telephony has made significant impact in India, with India now adding 100 million mobile phones a year. The total number of mobile phones is likely to touch 500 million by 2010 or 2011. It is likely that most Indian families would own at least one mobile.

Mobile phones have a great capability of becoming devices for financial transactions, substituting cash and enabling funds transfer to become more widespread. Thus payment can be done from one individual's mobile to that of another; further the payment is equally possible whether the two individuals are at the same location or at different geographical locations. The transfer could be from one's bank account to another or from one's virtual account (held by a telecom operator or a third party) to that of another. The transfer would be secure, instantaneous and possible at anytime.

Mobile payments, though in their infancy, have made significant impact in several countries including the Philippines, Kenya, Japan and South Africa. The technology is quickly maturing and has great potential to substitute cash as well as help reach unbanked population. While today the authentication would be done by the possession of phones and a PIN (just like a card and a PIN for ATM machine), bio-authentication like fingerprint would be available in the next few years.

The question therefore is what is the best way for India to adopt this technology in its drive for financial inclusion? Many initiatives are underway as players—banks, telecom companies, other financial players—search for a viable M-banking model for Indian markets. Sensibly, the banking industry, telecom operators and technology providers have got together with academia and banking regulators to form the **Mobile Payment Forum of India (MPFI)**. The Forum examined the technology, business and regulatory issues to enable this service in India and its draft report has been released by the RBI for public comments. The early focus is on transactions from one bank account to another (as also from one card account to another) through mobile phones, given the need to ensure compliance with KYC and anti-money laundering guidelines, among other prudential requirements. Other modes of transfer will be explored in due course once experience is gained with the initial model. Right from the beginning, it is envisaged that the service would work in multi-operator (telecom) and multi-banking scenario.

The key is to discover the appropriate price point and consumer confidence in safety of transactions, only post which the Indian user would adopt mobile banking in a large way. Going by the experience of telecom operators, India adopts solutions only when it is very low priced, easy to use and safe, making it affordable to larger sections of people. The challenge would then be to develop the right technology so that the service providers and the banks consider this as a viable business.

done at a reasonable transaction cost. This would greatly incentivize the poor to make micro-savings and eventually become full-participants in the financial system. The government should explore on an expedited basis, together with deposit taking institutions, business correspondents, and technology providers, what aspects of the NEFIS could ride on the current backbone, what will need new infrastructure and common standards, and whether any incentives need to be provided to the system to undertake this task. The ambitious timeline should be adhered to.

Improving infrastructure for financial inclusion

The Committee believes that it is important to improve the infrastructure for inclusion. Section on 'Use technology to reduce cost of delivery' discusses the creation of NEFIS, which would be instrumental in facilitating the poor's access to the payments system. Chapter 7 deals extensively with the issue of credit infrastructure, including the creation of a national ID, the use of land as collateral, and personal bankruptcy, which are all measures that would improve the poor's access to financial services.

Another area that falls broadly in the ambit of financial infrastructure for inclusion is the provision of interest-free banking. Certain faiths prohibit the use of financial instruments that pay interest. The non-availability of interest-free banking products (where the return to the investor is tied to the bearing of risk, in accordance with the principles of that faith) results in some Indians, including those in the economically disadvantaged strata of society, not being able to access banking products and services due to reasons of faith. This non-availability also denies India access to substantial sources of savings from other countries in the region.

While interest-free banking is provided in a limited manner through NBFCs and co-operatives, the Committee recommends that measures be taken to permit the delivery of interest-free finance on a larger scale, including through the banking system. This is in consonance with the objectives of inclusion and growth through innovation. The Committee believes that it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact.

Financial literacy

The Committee also believes that a significant investment in financial literacy is required if the poor are to make effective use of various initiatives to foster financial inclusion. A good understanding of the costs and benefits of various financial services, the impact of inflation on savings, and the trade-off between risk and return can help households choose the right products for their needs and weed out dubious schemes from truly beneficial ones. The Committee believes that efforts to promote financial literacy should start early. Starting around Vth standard, students could be introduced to terms such as income, expenditure, savings, deposits, interest, insurance, etc. In addition, TV channels could be encouraged to run educational programmes on financial issues such as household budgeting, savings, insurance, and pensions. The proposed Office of the Financial Ombudsman could aggregate the funds currently set aside by various regulators for this purpose, and sponsor these shows (for example, SEBI has the Investor Education Fund and IRDA has the Insurance Fund). These efforts could also be sponsored by individual banks, insurance companies, etc.

NOTES

1. This evidence comes from the results of the 2007 IIMS Dataworks survey that was used as an input to this chapter.
2. For example, for priority sector loans below Rs. 2 lakh, the interest rate is capped at the Prime Lending Rate (PLR). Banks do have some flexibility in determining their PLR, an in addition, a nominal additional charge is allowed over and above the PLR

for loans above Rs. 25,000. But for loans below Rs. 25,000, where much of the poor's borrowing lies, no additional charges are permitted other than the PLR. The interest rate cap is however not applicable on certain categories including loans for purchase of consumer durables, to individuals against shares/debentures/bonds, and other non-priority sector personal loans.

3. The analysis in this section is based largely on a household survey of 100,000 respondents carried out by the Invest India Market Solutions (IIMS) in 2006–07 (and referred to as IISS 2007 or 'the Survey' in this chapter).
4. Approximately three-fourths of the total working population, or 321 million people in 2006, earn cash incomes (the rest are primarily unpaid family workers). Of those only 193 million or 60 per cent reported having any financial savings in formal and informal instruments.
5. For instance Kerala, which has the highest incidence of savings has also the highest proportion of cash earning adults with bank accounts. By contrast, Bihar with the lowest incidence of savings also has the lowest bank account penetration.
6. Other surveys have similar findings. For example, a 2004 Survey commissioned by the Ministry of Finance titled 'Pension Reforms for the Unorganised Sector in India' found that 94 per cent of existing earners were not saving or building up assets for retirement. This was despite the fact that 40 per cent of respondents in urban India and 30 per cent in rural India reported that they did not expect their children to take care of them in their old age, the traditional mode of funding retirement in India. In contrast, the Max New York Life—NCAER India Financial Protection Survey found that nearly 69 per cent households save for old age financial security.
7. RBI Annual Report 2006–07, p. 32.
8. Of the population citing wealth creation as their prime motivation for savings, 13.9 per cent and 15.1 per cent had invested in mutual funds and equities respectively.
9. At an aggregate level, the investor base for mutual funds and equities is small—mutual fund investors represent only 2.8 per cent of the total population with savings, while equity investors represent 1.9 per cent.
10. Capital gains from short-term sale of equities attract taxes, while sale of long-term equities (over one year) are not taxed. However, all interest over Rs. 10,000 earned on bank deposits is taxed. Clearly, the poorest households are likely to be exempt from taxes on deposit interest, but as interest rates rise, more households will pay taxes on deposit interest.
11. For traditional life insurance products, a policyholder typically loses the entire investment if the policy lapses within the first three years. After that, only the surrender value is paid in the case of a lapse, which is less than 35 per cent of the total premia paid. IRDA reported that almost 5 per cent of life insurance policies lapsed between 2000 and 2005. This number was as high as 16 per cent among private providers, due to higher contribution of ULIPs and aggressive selling policies. Source: ISEC Securities, 'Indian Life Insurance', 7 December 2007, p. 43.
12. World Bank-NCAER Rural Finance Access Survey, 2003.
13. Task Force on Revival of Cooperative Credit Institutions, December 2004, Chairman: Prof. A. Vaidyanathan.
14. The cooperative banking sector is undergoing extensive reform based on the recommendations of the Vaidyanathan Committee. The revival plan has been accepted by 17 states 'in-principle', while 13 states have signed MOUs with the government. It is imperative that the revival package is implemented in full, without diluting the contingent legal, financial, regulatory, and institutional reforms that in turn would entail significant decisions on the part of the participating state governments and cooperative credit societies. This would have the effect of cleaning the balance sheets and strengthening the capital base of rural cooperatives, and allay fears that the implementation of the revival package may not provide any substantial remedy to the problem of financial exclusion.
15. Though priority sector lending norms initially focused on increasing commercial finance to sectors deemed as 'national priority' since 1980, the scope of the priority sector has largely evolved to give greater prominence to segments of the population that have traditionally been denied credit, thus making it a tool to address financial inclusion. In 1980 the Working Group on Priority Sector Lending and 20-Point Economic Programme (Chairman: Dr. K.S. Krishnaswamy) introduced a focus on 'weaker sections' within the priority sector by identifying underprivileged segments that required access to banking services. The Committee also recommended separate subtargets for lending to the weaker sections within agriculture and SSI. The first Narasimham Committee (1991) proposed a redefinition of the priority sector to comprise small and marginal farmers, the tiny sector of small-scale industry, small business and transport operators, rural artisans, and other weaker sections. The C.S. Murthy Committee (2005) further redefined the priority sector to include those sectors that 'affect large sections of society, benefit small borrowers and involve small loans, and lead to substantial employment generation'.
16. The bulk of lending in that category appears to be in the form of large ticket loans to farmers with larger landholdings. While marginal farmer households comprise over 66 per cent of all farmer households, the share of credit accounts among this section of farmers barely increased between 1991 and 2005, while the share of credit accounts for medium and large farmers increased by 41 per cent over the same period. Similarly, credit access among the tiny enterprises under the small and medium enterprise category fell post-2000 (Chavand and Ramkumar, 2007).

17. World Bank, 2007, *India: National Agricultural Insurance Scheme: Market Based Solutions for Better Risk Sharing*. p. 3.
18. Indian microfinance had a late start, well after Bangladesh, Indonesia, and Latin American countries. The key policy change that jumpstarted microfinance provision in India was RBI's 1996 decision to allow commercial banks to lend to self-help groups without collateral.
19. The SHG-Bank Linkage programme has been described as the largest microfinance intervention in the world (Christen, 2006).
20. In 2001, over 70 per cent of SHGs were located in the four southern states of Andhra Pradesh, Tamil Nadu, Karnataka, and Kerala. This number has fallen to 45 per cent in 2007 (Thorat et al., 2007).
21. Goldberg (2005). *Measuring the Impact of Microfinance: Taking Stock of What We Know*. Grameen Foundation USA Publication Series.
22. Khandker (2005). *Microfinance and Poverty: Evidence Using Panel Data from Bangladesh*. World Bank Economic Review.
23. Chen and Snodgras (2001). *Managing Resources, Activities and Risk in Urban India: The Impact of SEWA Bank*.
24. Apart from loans, MFIs have been able to raise equity financing from private equity players. The securitization of MFIs portfolios also provides an attractive source of finance.
25. See Berger et al. (2005).
26. Thorat (2007).
27. The Local Area Bank Scheme, initiated in August 1996, was set up with the intent of creating new local, private banks with jurisdiction over three contiguous districts that would mobilize rural savings and make them available for investments in the local areas. Only six were approved initially, and four are currently in operation. The LAB scheme was never given a serious try, and this is unfortunate because every proposal for small banks meets the rejoinder 'the LABs did not work'. This largely inaccurate conclusion stems from over-interpreting a 2002 RBI internal review group, which examined the operations of the four existing LABs. While admitting that it was too early to make strong judgements, and despite the banks being profitable, meeting priority sector targets, and maintaining high credit-deposit ratios, the Review Group recommended that until existing LABs achieved a measure of financial soundness, no more LAB licenses were to be issued. The Review Group also recommended, on the basis of a priori reasoning, and the RBI accepted, that size was important in banking, and therefore the capital base of the existing LABs be increased from the initial Rs. 5 crore to Rs. 25 crore over seven years, and that LABs should maintain a minimum capital adequacy ratio of 15 per cent given the higher level of risks they face. The Khan Committee, which examined issues relating to rural credit and microfinance (2005) and the Rangarajan Committee on Financial Inclusion (2008) have supported the revival of the LAB scheme. The latest figures show LABs have profits to assets of about 1.2 per cent, which is about the same as other banks.
28. Committee members were hesitant to mandate an explicit loan ceiling, but the idea is that the average ticket size of loans made by small finance banks would be much smaller than those of SCBs.
29. Since these banks would be serving a large section of farmers, they would provide simpler derivative products to hedge price risks. They could simply aggregate the demands of farmers and purchase the necessary exchange traded or OTC products, without the need for hedging operations.
30. Examples include Rabobank in Netherlands and BANSEFI in Mexico.
31. In 2005, the RBI allowed banks to use business correspondents (BCs) and facilitators (BFs). A number of entities can serve as BCs—cooperatives, Section 25 companies, non-deposit taking NBFCs, post offices, etc.
32. The 2008 Budget announced that a number of additional categories would be eligible to be BCs, such as retired bank officers, ex-servicemen, etc.
33. The RBI report has proposed a Moneylenders & Accredited Loan Providers Bill, 2007. Under this proposed legislation, moneylenders who sign up to a model code of conduct detailed in the legislation could be offered finance from the formal system.
34. Brazil and South Africa are good examples. The South African low-frills Mzansi bank account can be accessed through various non-bank locations. In India, the underdeveloped organized retail sector has been a constraint in scaling up such partnerships. However the postal network of India Post, which has the largest number of branch offices in the country, is a potentially viable channel for expanding financial service delivery. India Post is already a large repository of household savings and the largest provider of remittance services. Unfortunately, India Post's past role in playing a larger role in financial services has been checkered. This is largely due to weak management and governance issues that must be tackled. Clearly a revamping is underway as evidenced by recent announcements of various tie-ups between India Post and various financial institutions.
35. An example is the Mahatma Gandhi Bunkar Bhima Yojana (MGBBY), a group insurance scheme for handloom weavers. The scheme offers insurance cover of Rs. 50,000 for natural death, and Rs. 80,000 for accidental death. In 2005–06, weavers had made claims of only Rs. 1.67 crore out of the premium amount of Rs.13 crore paid by the gov-ernment to insurance companies (Source: Press Information Bureau, November 2006 and *Hindu Business Line*, 6 September 2006).

    In contrast the NAIS, described in Section III, is unable to collect adequate premia to meet the required payout.
36. The government has announced plans for a subsidized national health insurance scheme for unorganized workers. This scheme shifts government spending to demand-side subsidies away from supply-side spending. A McKinsey &

Company report argues that this scheme could be enhanced by leveraging the country's civic institutions as 'social aggregators' uniquely capable of rapidly bringing large numbers of citizens into a health insurance system. Social aggregators can act as informed consumers on behalf of their members, while simultaneously improve risk sharing and reduce the likelihood of fraud and moral hazard.

37. The first Narasimham Committee (1991) proposed that the scope of directed lending under priority sector be reduced from 40 per cent to 10 per cent. This was not accepted. The second Narasimham Committee (1998) noted the reasons why priority sector obligations could not be reduced while stressing that priority loans be appraised on commercial considerations without any extraneous influences. The High Level Committee on Agricultural Credit through Commercial Banks (R.V. Gupta Committee, 1996) noted that the target of 18 per cent for lending to agriculture was fixed when the reserve requirements were 63 per cent. Due to progressive reduction of the reserve requirements over the years, the total lendable resources of banks have increased substantially. The Committee estimated that the base on which the target of 18 per cent was calculated had doubled; thus the banks would have to double their lending to agriculture just to maintain the same share in conditions where agricultural production itself was growing at 2.1 per cent per annum. It suggested that banks prepare special agricultural credit plans and set their own lending targets for agriculture based on Reserve Bank's expectation of increase in the flow of agricultural credit on an annual basis.
38. RBI could periodically collect and publish information on costs of lending to particular hard to reach segments and disseminate such information in its various publications, highlighting cases where entities have achieved significant cost reduction in providing such credit. Such information would exert pressure on banks to find ways to reduce the cost of credit provision in the priority sector, and could also be used to judge reasonable margins.
39. Government of Andhra Pradesh concluded successful pilot routing social security payments to widows, handicapped, old and eligible weavers through the use of smart cards and BCs.
40. Sinha, J., and A. Subramanium, 2007, *The Next Billion Customers: A Road Map for Expanding Financial Inclusion in India*. Boston Consulting Group.
41. The Committee recognizes that 90 per cent of households are likely to be covered in three years. The remaining 10 per cent would be difficult to reach, and the goal should be to cover those in the following two years.

REFERENCES

Basu, Priya, 2006, *Improving Access to Finance for India's Rural Poor*, Washington: World Bank.

Bays, Jonathan et al., 2008, 'Promoting Financial Inclusion—Lessons from around the World', in *New Vistas in Financial Services,* McKinsey & Company, pp. 46–56.

Berger, Allen N., Nathan H. Miller, Mitchell A. Petersen, Raghuram G. Rajan et al., 2005, 'Does Function Follow Organizational Form? Evidence from the Lending Practices of Large and Small Banks', *Journal of Financial Economics,* 76 (May), pp. 237–69.

Chavan, Pallavi, and R. Ramkumar, 2007, *Revival of Agricultural Credit in the 2000s: An Explanation,* New Delhi: Jawaharlal Nehru University.

Chen, Martha A., and Snodgrass, Donald, 2001, *Managing Resources, Activities and Risk in Urban India: The Impact of SEWA Bank,* Washington: AIMS.

Christen, R.P., 2006, 'Microfinance and Sustainability: International Experiences and Lessons in India', in *Towards a Sustainable Microfinance Outreach in India*, New Delhi: NABARD GTZ and STZ.

CGAP Focus Note No. 43, 2008, *Regulating Transformational Branchless Banking: Mobile Phones and Other Technology to Increase Access to Finance,* Washington: Consultative Group to Assist the Poor.

Cowley, Amanda, and Tilman Ehrbeck, 2007, *Health Insurance for the Poor: Leveraging India's Unique Strengths,* part of Sustainable Health Insurance: Global Perspectives for India, pp. 30–42, McKinsey & Company.

Ghate, Prabhu, 2007, *Microfinance in India: A State of the Sector Report, 2007,* New Delhi: Microfinance India.

Goldberg, Nathanael, 2005, *Measuring the Impact of Microfinance: Taking Stock of What We Know,* Grameen Foundation USA Publication Series, Washington: Grameen Foundation USA.

Gupta, S.C., 2007, *Report of the Technical Group to Review Legislations on Money Lending*, RBI Technical Working Group (http://rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=513).

Helma, Brigit, and Xavier Reille, 2004, 'Interest Rate Ceilings and Microfinance: the Story so Far', CGAP Occasional Paper No. 9, Washington: Consultative Group to Assist the Poor.

Invest India Market Solutions Pvt Ltd (IIMS Dataworks), October 2007, *Financial Inclusion and Access: Discussion Paper*, prepared exclusively for the Committee on Financial Sector Reforms, based on the findings of the *Invest India Income and Savings Survey 2007,* India.

Khan, H.R., 2005, *Final Report of the Internal Group to Examine Issues Relating to Rural Credit and Micro finance,* RBI Internal Working Group.

Khandker, Shahidur, 2005, *Micro-finance and Poverty: Evidence Using Panel Data from Bangladesh,* World Bank Economic Review, Washington: World Bank.

Kumar, Anjali, Ajai Nair, Adam Parsons, and Eduardo Urdapilleta, 2006, *Expanding Bank Outreach through Retail Partnerships, Correspondent Banking in Brazil,* World Bank Working Paper No. 85, Washington: World Bank.

Mor, Nachiket, and Bindu Ananth, 2006, *Inclusive Financial Systems: Some Design Principles and the Case Study of ICICI Bank,* Centre for Development

Finance Working Paper Series, Chennai: Institute for Financial Management and Research.

Murthy, C.S., 2005, *Draft Technical Paper by the Internal Working Group on Priority Sector Lending,* RBI Internal Working Group.

Narasimham, M., 1998, *Report of the Committee on Banking Sector Reforms,* Ministry of Finance, Government of India.

Natu, A.J., Aashish Bansal, Amrita Kurian, Gurinder Pal Singh Khurana, and Tanushree Bhushan, 2008, 'Linking Financial Inclusion with Social Security Schemes', Centre for Microfinance Working Paper Series No. 22, Chennai: Institute for Financial Management and Research.

New South Global Pty Limited, 2006, *India—Pension Reforms for the Unorganised Sector, Final Report,* Technical Assistance Consultant's Report, Asian Development Bank, for the Ministry of Finance, Government of India.

Petersen, M.A., and Rajan, R.G., 1994, 'The Benefits of Firm-Creditor Relationships: Evidence from Small Business Data', *Journal of Finance*, Vol. 49, p. 3.

Radhakrishna, R., 2007, *Report of the Expert Group on Agricultural Indebtedness*, Ministry of Finance, Government of India.

Ramachandran, G., 2002, *Report of The Review Group on The Working of the Local Area Bank Scheme,* Reserve Bank of India.

Rangarajan, C., January 2008, *Report of the Committee on Financial Inclusion*, Ministry of Finance, Government of India (http://www.nabard.org/report_comfinancial.asp).

Reserve Bank of India, July 2007, *Master Circular—Lending to Priority Sector*, RBI/2007–08/34, RPCD. No. Plan. BC. 5/04.09.01/2007–08.

Sengupta, Arjun K., 2007, *Report on Conditions of Work and Promotion of Livelihoods in the Unorganised Sector,* National Commission for Enterprises in the Unorganised Sector, New Delhi: Government of India.

Shukla, Rajesh, 2007, *How India Earns, Spends and Saves,* New Delhi: The Max New York Life—NCAER India Financial Protection Survey.

Sinha, Janmejaya, and Arvind Subramanian, 2007, *The Next Billion Consumers, A Road Map for Expanding Financial Inclusion in India,* Boston: The Boston Consulting Group.

Thorat, Usha, 2007, 'Urban Cooperative Banks: Evolution of the Banks, Current Issues in Corporate Governance and Challenges in their Regulation and Supervision', *RBI Monthly Bulletin*, January.

Thorat, Yashwant, Howard Jones, and Marylin Williams, 2007, *Rural Financial Institutions and Agents in India: A Historical and Contemporary Comparative Analysis,* presented at the International Conference on Rural Finance Research: Moving Results into Policies and Practice, Italy, FAO.

Torre, Augusto de la, Juan Carlos Gozzi, and Sergio L. Schmukler, 2007, 'Innovative Experiences in Access to Finance: Market Friendly Roles for the Visible Hand?', World Bank Policy Research Working Paper 4326, Washington: World Bank.

Vaidyanathan, A., 2004, *Draft Final Report of the Task Force on Revival of Cooperative Credit Institutions*, Ministry of Finance, Government of India.

Verma, Niraj, and Olivier Mahul, 2007, *India—National Agriculture Insurance Scheme: Market-based solutions for Better Risk Sharing*, Report No. 39353, India Country Management Unit, Washington: World Bank.