



Building a more inclusive financial system in India the way forward

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Abstract

The latest agenda on which the RBI has been putting a great deal of focus is the issue of financial inclusion. An important question arises here is; why are we talking of financial inclusion now? The key driving force behind this approach is due to: focus on inclusive growth, banking technology has arrived and realization that poor is bankable. That is why; more and more emphasis has now been placed on building a more inclusive financial system that is based on lessons of the past. In fact, the past strategy for inclusion had mixed results. There are millions of bankable peoples in rural areas that are unbanked because of access and usage issues. Hence, a new and multi-pronged approach is needed to make the Indian banking system more inclusive in nature. This will require a concerted effort by several stakeholders (including the government of India, RBI, NABARD and commercial banks, RRB. etc.) to figure out effective way to provide financial services to the poor. It should lead to a set of financial sector reform that explicitly prioritizes inclusion.

This paper covers the issues of financial inclusion amongst rural communities in India by discussing- i) brief introduction of the current state of banking in India, ii) defining financial inclusion and steps taken for, iii) the key drivers of financial inclusion, focusing on access and usage issues, iv) finally, the way forward with potential solutions and suggestions to address the problems of financial inclusion.

Keywords: banking, financial inclusion

Introduction

Building an Inclusive Financial system has gained growing global recognition bringing to the fore the need for development strategies that touch all lives, instead of select few, and is integral to the Inclusive growth process. In fact, 'Finance' itself is widely recognized in the Endogenous growth strategy as a crucial factor of production such as knowledge and the influence of institutional arrangements with regard to finance on growth rate has been forcefully emphasized. At present, India is the 12th largest economy in the world in terms of GDP and 4th in terms of purchasing power parity (PPP). The growth rate of the economy is equally impressive, not only compared to its past but also in comparison with other countries (figure-1).

But fact is that, A high rate of growth would have little meaning to the poor unless there is a visible improve in their living and working condition, i.e. a major concern is balanced growth to bridge the divide and avoid exclusion. To this imperative, access to finance is an essential pre-condition to ensuring overall economic growth, as it will empower the vulnerable groups by giving them an opportunity to have a bank account, to save and invest and thereby facilitating them to break the chain of poverty. Thus, A new and multi-pronged approach to Inclusive finance is needed that build 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 way to provide financial services to the poor. It should lead to a set of financial sector reforms that explicitly prioritize inclusion.

Defining inclusive financial system

The essence of financial Inclusion is in trying to ensure that a range of appropriate financial services is available to every individual and enabling them to understand and access those services, that is, Universal access to a wide range of financial services at a reasonable cost. In its landmark research work titled- 'Building Inclusive financial Sectors for development (2006), the United Nations has raised the basic question: why are so many bankable people unbanked. And defined as- *"An inclusive financial sector would provide access to credit for all bankable people, to insurance for all insurable people and to savings & payments services for every one."*

According to the committee on financial inclusion, as working definition: Financial inclusion may be defined as- *"The process of insuring access to financial services and timely & adequate credit were needed by vulnerable groups such as weaker sections & low income groups at an affordable cost."*

Thus, as financial services are in the nature of public goods, Inclusive finance should therefore be viewed as availability of banking and payment services to entire population without discrimination of any type.

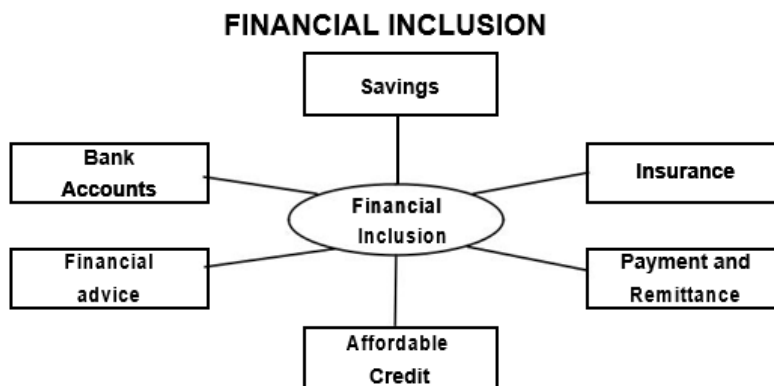


Fig 1

While financial inclusion, in narrow sense, may be achieved to some extent by offering any one of these services, the objective of comprehensive financial inclusion would be to provide a holistic set of services encompassing all of the above (in figure).

Steps taken for inclusion

Since independence, the Government of India and the RBI have made concerted efforts driven by the objective of increasing financial inclusion. Accordingly, they have taken several initiatives, from time to time, such as – nationalization of banks, prescription of priority sector lending norms and concessional interest rate, were all elements of 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 institution (such as- RRBs and Co-operatives) and setting targets for credit to broad categories of excluded. The recent measures have been introduced to promote inclusion, such as- making available a basic banking ‘No-frills account’; simplifying KYC norms; introduction of General Credit Cards in rural & semi urban centers; introduction of BF and BC model; setting up the ‘FI fund’ & ‘FI technology fund’ with Nabard to provide funding supports and finally, RBI has been putting a great deal of focus is the issue of financial inclusion, a landmark agenda in 11th five year plan. Its success has been mixed and has been showing diminishing returns³⁰. In fact, still we have failed to

reach the large numbers of population residing in the rural areas. The rural poor continue to depend on informal sources to credit and the predominant lender to the poor is still the moneylender, because he is flexible, does not need documentation, is prompt and can respond to his client’s emergency needs very well. Due to this fact, the share of moneylenders in total non-institutional credit was declining till 1981, started picking up from the 1990s and reaching 26.8% in 2002.³³

Extent of exclusion

As per NSSO data, 45.9 million farmer households in the country (51.4%), out of a total of 89.3 million households do not access credit, either from institutional or Non-institutional sources. Only 27% of total farm households are indebted to formal sources (of which one-third also borrow from informal sources). Overall, 73% of farm households do not have access to formal credit sources. It means that, financially excluded households will be defined as those not having any debt to formal sources³⁴.

Region Wise

The farm households not accessing credit from formal sources as a proportion to total farm households is especially high at 95.91%, 81.26% and 77.59% in the North Eastern, Eastern and Central Regions respectively. In terms of absolute numbers these regions taken together account for 64% of farm households not accessing credit from formal sources as detailed below:

Table 1: No. of farmer households (HH) in Lakh

Region	Total HHs	Indebted HHs	% to total	Nonindebted HHs	% to total	Indebted Formal sources	% to total	Excluded by Formal sources	% to total
Northern	109.46	56.26	51.40	53.2	48.60	27.423	25.05	82.04	74.95
North Eastern	35.40	7.04	19.90	28.36	80.10	1.448	4.09	33.95	95.91
Eastern	210.61	84.22	40.00	126.39	60.00	39.467	18.74	171.14	81.26
Central	271.33	113.04	41.60	158.29	58.40	60.814	22.41	210.52	77.59
Western	103.66	55.74	53.70	47.92	46.30	45.586	43.98	58.07	56.02
Southern	161.56	117.45	72.70	44.11	27.30	69.072	42.75	92.49	57.25
Group of UTs	1.48	0.49	33.10	0.99	66.90	0.15	10.14	1.33	89.86
All India	893.50	434.24	48.60	459.26	51.40	243.96	27.30	649.54	72.70

Level of indebtedness to institutional sources

Derived data indicate that only 27.3% of the total farm households were indebted to institutional sources as for

‘others’ category (2.44 crore), followed by agricultural labourer households (1.67 crore) and artisans (0.55 crore) as shows in table below:

Table 2

Region	Total no. of HHs (lakh)	Incidence of indebtedness to both formal and non-formal sources		Indebtedness to institutional sources	
		Lakh HHs	(% to total HHs)	Lakh HHs	(% to total HHs)
Northern	109.46	56.26	51.39	27.42	25.05
North Eastern	35.40	7.04	19.88	1.45	4.09
Eastern	210.61	84.22	40.01	39.47	18.74
Central	271.33	113.04	41.66	60.81	22.41
Western	103.66	55.74	53.77	45.59	43.98
Southern	161.56	117.45	72.70	69.07	42.75
Group of UTs	1.48	0.49	33.10	0.150	10.14
All India	893.50	434.24	48.60	243.96	27.30

Level of non-indebtedness: Across social groups

The highest levels of non-indebtedness to both formal and non-formal sources is observed among Scheduled Tribes (ST)

with 63.7%, followed by Scheduled Castes (SC) with 49.8% as shows in table below:

Table 3

Households	Sche-duled tribes	Sche-duled castes	Other backward classes	Others	All
Total no. of farmer HHs (lakh)	119.24	155.93	370.43	247.90	893.50
Non-indebted farmer HHs (lakh)	75.94	77.60	179.96	125.76	459.26
Proportion of non-indebted farmer HHs (%)	63.69	49.77	48.58	50.73	51.40

Exclusion among all non-cultivator households

Incidence of financial exclusion among all non-cultivator households was estimated at 78.2% which comprises of 78.8% of agricultural laborer households, 71.4% of artisans and

79.7% of other rural households. Out of 5.96 crore non cultivator households about 4.66 crore were estimated to be financially excluded. The number of non-cultivator households affected by financial exclusion was the highest

Table 4

Households	Agricul-tural labourers	Artisans	Others	Total non-cultivators*
Number of households (crore)	2.12	0.77	3.06	5.96
Number of households facing financial exclusion (core)	1.67	0.55	2.44	4.66
Incidence of financial exclusion (%)	78.80	71.40	79.70	78.20

Agricultural labourers, artisans, others (as per national classification of occupations, 1968) data based on AIDIS report on household Indebtedness in India (59th round). NSSO.

Key drivers of financial exclusion

Despite the major initiatives taken by several stakeholders (Government of India, RBI, Nabard and Banks etc), there is large variation in banking penetration within Urban and Rural areas. While urban areas seems to be over banked (many urban peoples have more than one bank account), rural areas lags far behind. i.e., sub-optimal outreach in rural areas. This low outreach can be explained by two key parameters:

Access
Usage

Simply defined, access is the availability of financial and usage is the actual use of those services. Access and usage are not synonymous, as people may have access to financial services, but decide not to use them, either for socio-cultural

reasons or because opportunity costs are too high. Access includes issues such as the basic economic state of rural India, lack of physical infrastructure facilities, regulatory constraints, and the economics of rural banking, which is associated with key factor like- low ticket size, high cost to serve, higher risk of credit due to irregular & volatile income streams, information asymmetry and NPAs etc. while usage includes social issues such as illiteracy, incomplete service offerings by banks, and high transaction costs in the formal banking system. In fact, even if access to formal banking is provided to rural populations, there is no guarantee that these services will be used. To compound the situation, many customers in rural India, who have access to and would otherwise choose to use formal financial services, do not do so because the product and services mix do not meet their small and frequent needs (figure).

Rural poor – financial needs and services requirements

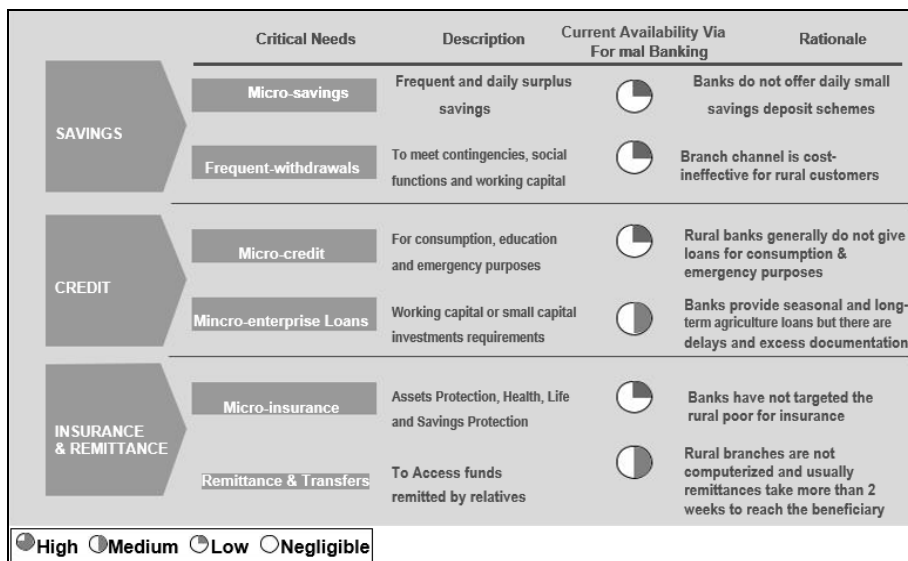


Fig 2

In addition, due to cumbersome procedures and risk perceptions of the banks, in dealing effectively with a large number of borrowers, left a gap in serving the credit needs of the rural population. Therefore, the question is how to extend the scope of activities of formal financial system to include low income groups. Thus, an understanding of which is critical to increase usage- not just availability- of formal financial services, is needed.

The way forward

As Dr. Muhammad Yunus stated in his Nobel peace prize acceptance speech at Oslo, *“We get what we want or what we don’t refuse. We wanted to go to the moon & we had reached the moon. We achieve what we want to achieve and if we do not achieve something, it means that we have not put our mind into it.”* *“We should believe that if we want to achieve 100% financial inclusion, we will achieve it. What is needed is only the resolve to make it happen.”* 35

Hence, there is need to figure out the effective ways and new delivery mechanism that fulfills the small and frequent needs of hitherto unbanked masses. At present, there are number of players in the field of financial inclusion, some weak, some strong, some with strong presence, some without a background, some promoted and run by professionals & individuals. All of them offer different mechanism but for the same ultimate objective, i.e., financial inclusion. In fact, it is a complex issue which cannot be solved single handily by any stakeholder in the system. It will require a holistic approach and a mix of banks and other intermediaries along with the regulatory body, who can help to meet this demand- supply, mismatch as an explicit strategy for faster economic growth in much more inclusive masses.

In building an inclusive financial system, each of three key stakeholders- the government of India, RBI and banks- has a role to play (figure).

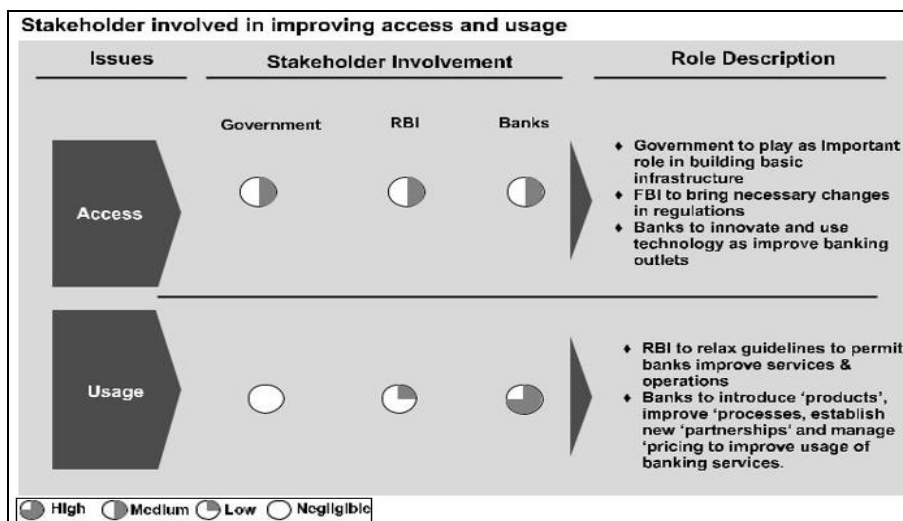


Fig 3

We focus on the actions to be taken by banks because they are able to more rapidly implement change than the other two. Even within the sub-optimal infrastructure and regulatory framework laid out by the government and RBI, there is an opportunity for banks to improve the rural customers' access and usage. Access can be enhanced through new and innovative channels which the RBI already permits, and leveraging cost effective technology in existing channels. Usage can also be improved if banks revise their product and service offering to meet the needs of the rural customer. Therefore, to improve access in rural areas, banks need to modify existing channels, introduce new channels and identify innovative ways to merge the two.

Modify existing channels

Branches: To reduce the costs imposed by branches, banks should consider the option of sharing their branch infrastructure. This would be similar to the example of the telecom industry sharing network.

ATMs

ATMs are an effective channel which can deliver many of the services frequently used by a bank customer. However, ATMs, in their current form, are not suitable for rural areas as the literacy level and transaction ticket amount is too low. ATMs can, however, be designed to meet the needs of rural customers. In addition to modifying the design of the machines, banks should also hold discussions with the RBI to allow an attendant to be posted at ATMs. This will certainly enhance the usability of ATMs.

Phone Banking and Internet Banking: Though this is a cost-effective channel, given very low tele-density and low internet penetration in rural areas, the ability to use this channel to reach the rural customer is low. However, this channel should be considered, once infrastructure and literacy levels improve in rural India. A business correspondent could then run an e-kiosk to assist customers to transact over these channels.

Point of Sale (POS): Business correspondents can be provided with POS to allow customers to deposit and withdraw cash from their accounts. Combining POS with a smart card is one way to improve access. Brazil has successfully used banking correspondents who use POS and card readers to provide current accounts, loans, and insurance, accept bill payments, and perform other transactions.

Introduce new channels

Microfinance through SHGs and MFIs

The concept of microfinance refers to a particular subset of financial services, which is small in magnitudes and those who avail services are poor. Now it has engendered a new relationship between the banks & poor, based on sound business principle and enable the poor to approach banks as customers, not as beneficiaries. Using group-based lending microfinance provides financial services (largely credit) using process that work and is in close proximity to the client. Group is viewed as standing in place of collateral, i.e., social collateral. That is why the main focus has been placed on

formation of groups because it has double advantage of lowering transaction costs and improving repayment. Two models of microfinance are practiced in India- i. SHG-Bank linkage model, and ii. MFIs model, where MFIs borrow funds from bank to on lend to clients. Hence, the need of time is to appreciate it and see that it grows faster than now.

Business correspondents and business facilitator

As per, the RBI allows banks to appoint BFs and BCs to be used as intermediaries in providing banking services. In fact, this is the most innovative ways related to more intensive use of MFIs, NGOs, section 25 companies, registered NBFs not accepting public deposits and post offices, etc. they perform their role as agency banking. Through the BFs model, the banks would use the services of intermediary as agents for providing various facilitation services such as-identification of borrowers, collection of loan applications & post sanction monitoring, but this model does not evolve any conduct of banking business by concerned BFs, they will render services only as agents. In the BCs model, it would embrace activities within the normal course of a bank banking business.

Satellite offices a cost effective alternative to branches. These offices can be established at fixed premises in villages and are controlled & operated from a base branch located at a block head quarters. All types of banking transactions may be conducted at these offices. This channel is relatively less expensive, as it can draw personnel from the main branch and can remain open for just two days a week. It, therefore, is appropriate in blocks and districts which are densely populated.

Mobile Offices

Where banks do not find it economical to open full fledged branches nor satellite offices, banks may open mobile offices. It involves extension of banking services through a well-protected truck or van that visits villages on specified days/hours. This will not be dissimilar to the mobile ATMs implemented by some of the banks in the urban areas.

Determine the combination of channels

There is no one right channel to improve access in rural areas. Banks have to trade off between these channels that are most convenient to customers and those that are most profitable. Thus, the best solution to improve access will likely be permutation combination of these channels, like

▪ **Branches and satellite branches**

A low cost custom-made ATM managed by BCs to bring down the operating cost and scale the channel.

An e-kiosk managed by BCs with internet banking, ATM and POS terminal in relatively large rural areas.

This list highlights the need for creative solutions that marry the right channel to the right market and transaction.

To improve Usage, banks need to improve their product mix such as- Reduce total transaction cost, provide convenience and clearly outline the eligibility criteria for product and services. As shows in figure.

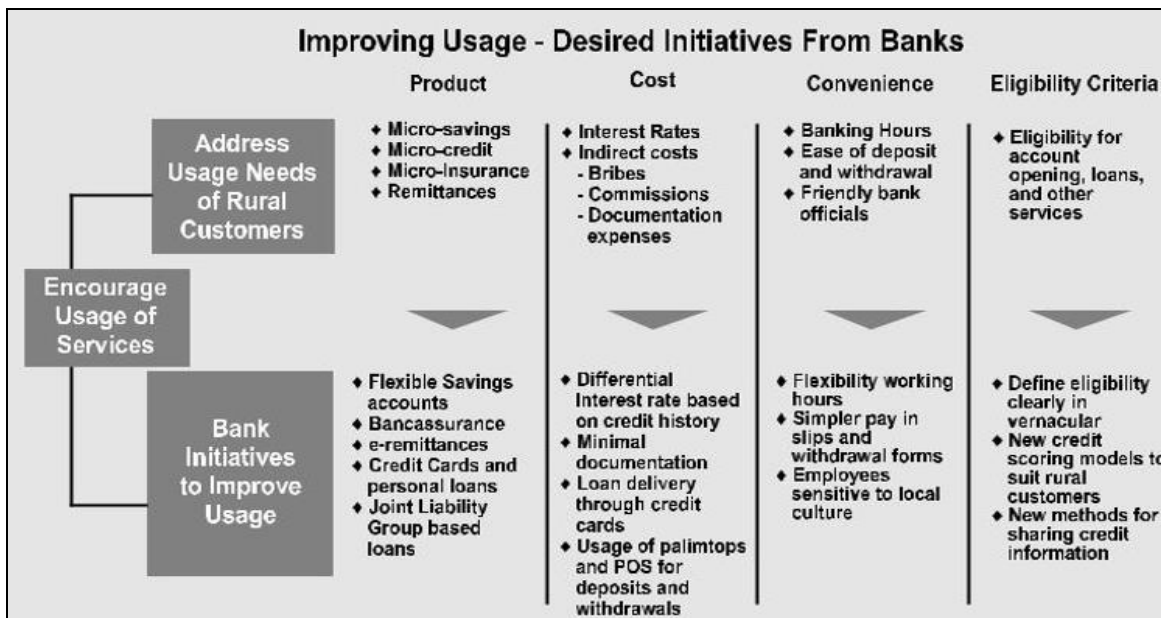


Fig 4

Conclusion

Overall, the above discussion shows that, the past strategy for inclusion had mixed results. There are millions of bankable peoples in rural areas that are unbanked because of access and usage issues. This presents a significant opportunity for banks. However, to reach this market and subsequently build an inclusive financial system, there must be a coordinated and concerted effort by the three key stakeholders; - The Government of India, the RBI and Banks. In addition, partnership between banks and BCs, MFIs & collaboration amongst banks themselves is critical. Furthermore, banks should tailor their product & service mix to meet rural needs and changes their delivery model to meet the demands of rural customer in a profitable manner & much inclusive trend. However, the concept of concessional credit has to be replaced by an approach in which banks act not merely as financiers but they become business partners. Not only by just providing credit to the people, but by being initiators and active share holders of economic activity, they will motivate and create economic enterprises by using latent capabilities of vast rural masses.

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