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The Status of Financial Inclusion, Regulation, and Education in India

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Abstract

India's financial inclusion agenda has witnessed a paradigm shift over the last decade, away from an emphasis on credit to a more comprehensive approach toward financial services (e.g., opening bank accounts and offering basic financial products, such as insurance). This paper describes the structure of banking and microfinance institutions in India relevant to the developing model of financial inclusion, as well as relevant regulatory structure and modes of delivery. It explains the current state of financial inclusion, as well as regulatory changes necessary to make the new architecture for inclusion viable, including a critique of some of the recommendations of the Mor Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households. The paper then reviews modes of delivery and the regulatory structure being contemplated or recently introduced. It assesses the suitability objective envisaged as critical for inclusion, associated challenge of revamping consumer protection laws, and imperative of improving financial literacy. The paper also discusses the case of micro, small, and medium-sized enterprises in the given context.

JEL Classification: G21, G28, L53, O16

Contents

1. INTRODUCTION: THE PARADIGN SHIFT IN THE CONCEPT OF FINANCIAL INCLUSION

Among economists, the general consensus is that financial development acts as a catalyst in the overall growth and development of an economy. Moreover, empirical research demonstrates that development of a strong, sound financial system contributes to economic growth (Rajan and Zingales 2003). As a result, most developing country governments are promoting financial inclusion[1] as a policy goal, especially for those who are ignored by formal sector institutions.

In India, financial inclusion has always been a priority, given the country's socialist beginnings. Since 1969, when banks were nationalized, the strategy for addressing the banking needs of the poor has been biased toward providing credit, neglecting other aspects, such as building a deposit base, promoting a savings culture, or extending the payment network. This credit drive was implemented in two ways: (i) directing a significant fraction of credit directly to credit-starved poor households and micro, small, and medium-sized enterprises (MSMEs) through priority sector targets for banks; and (ii) creating specialized entities, such as regional rural banks and cooperative banks. This policy has met with limited success, as banks find it difficult to reach the intended beneficiaries, instead meeting their priority sector targets by lending to other intermediaries, such as microfinance institutions (MFIs) that have emerged largely due to the failure of banks to promote financial inclusion.

However, over the last decade, India's financial inclusion agenda has seen a paradigm shift from an emphasis on credit to a more comprehensive approach toward financial services, particularly opening bank accounts and offering basic financial products such as insurance. This shift has been partly driven by the need to achieve other public policy goals, such as replacing product subsidies with cash transfers, which requires beneficiaries to have bank accounts for expediting the transfers. The concern regarding growing macroeconomic imbalances, such as a fall in the rate of financial savings that partly reflects a lack of adequate penetration of bank branches, has also been a driver.

This new approach necessitates a change in the financial architecture of India's economy. Since bank account creation is an integral part of the agenda, banks must be more directly involved, as regulations mandate deposit taking as their exclusive domain. Their efforts also need to be supplemented by intermediaries, such as business correspondents. Moreover, access to a robust payment network warrants the entry of specialist payment banks. Thus, the new inclusion drive involves multiple entities, and further involves MFIs. Yet there is a need for balance: risks, such as stability, solvency, anti-money laundering, and combating the financing of terrorism, must be addressed through regulation, while also ensuring that such regulation does not stifle inclusion.

It is important to note that financially excluded households and microenterprises must deal entirely in cash yet are susceptible to irregular and uncertain cash flows. Moreover, due to lack of access to formal institutions, financially excluded segments

[1] In 2008, the Committee on Financial Inclusion defined financial inclusion as "the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost" (Rangarajan 2008). This definition was later enhanced by the Reserve Bank of India (RBI): "financial inclusion is the process of ensuring access to appropriate financial products and services needed by vulnerable groups such as weaker sections and low income groups at an affordable cost in a fair and transparent manner by mainstream institutional players" (RBI 2014a).

have limited options for building assets or saving for their old age. The lack of savings and savings avenues forces them to approach informal sources of finance, which often charge 60%–100% in annual interest payments. Exposure to high rates of interest, and the inability to service such loans, ensures that these borrowers remain trapped in debt, exacerbating the cycle of poverty. The new agenda for financial inclusion seeks to address both of these long-standing concerns for India.

2. STRUCTURE OF THE BANKING AND MICROFINANCE INSTITUTION SECTOR IN INDIA

Soon after independence in 1947, a highly regulated banking system was put into place. Nationalization of the Imperial Bank, as the State Bank of India in 1955, was followed in 1969 by 14 private sector commercial banks. In 1991, the banking industry was deregulated by allowing entry of new private sector banks and increasing the limit of foreign equity to 74% in private sector banks. Simultaneously, licensing of branches of domestic-scheduled commercial banks was phased out, and interest rates were deregulated.

Today, India's banking sector is diversified (Table 1), reflecting the banking needs of various sectors. Besides typical commercial banks, which operate on all-India basis, there are small banks with limited areas of operation that were set up to further financial inclusion and poverty alleviation. Credit cooperatives serve the needs of small and marginal farmers as well as the poor in urban and semi-urban areas. Regional rural banks were created to bring together the positive features of credit cooperatives and commercial banks to address the credit needs of poor rural areas (Gandhi 2015). Local area banks were expected to fortify the institutional credit framework in rural and semi-urban areas.

Indeed, India's banking system has grown rapidly over the years (Table 2). Over the last decade, India has witnessed a credit boom, with the share of credit–gross domestic product (GDP) increasing from 35.5% in 2000 to 51.0% in 2013, the bulk accounted for by bank lending (MOF 2015b).[2]

Public sector banks dominate the landscape, with a market share in total deposits of around 74.0%; the share in total advances was 73.2% as of March 2015 (Table 3). Yet their performance, compared to their private sector counterparts, has been weak. Their gross nonperforming loans (NPLs) were 4.36% versus 3.83% for all banks; their total stressed assets were 10.67% versus 9.03% for all banks. New private sector banks recorded much lower NPLs of 1.73% and total stressed assets of 3.28%. Of course, there is significant variation in performance across public sector banks (RBI 2013b).

A specific challenge confronting banking in India is to resource public sector banks to overcome the problem of stressed and restructured assets to meet the imminent Basel III requirements of capital adequacy. Recapitalization requirements for public sector banks have been estimated to range from Rs48 trillion ($800 billion) to Rs100 trillion ($1.6 trillion), depending on the assumptions of forbearance and ratio of restructured assets turning into NPLs (RBI 2014c).

[2] Empirically, it has been shown that as countries become richer, they tend to see a rise in credit, but the share of the banking sector in total credit shrinks over the course of development relative to other sources of funding such as capital markets (MOF 2015b).

Table 1: Structure of Banking in India

Type of Bank	Composition	Bank Name	Number of Branches
Commercial Banks	Public sector banks (26) (72,661 branches)	State Bank of India	14,699
		Associate banks	5,482
		Nationalized banks	52,480
		Other public sector banks	1
	Private sector banks (20)	Old private sector	6,047
		New private sector banks	9,522
	Foreign banks (43)	Branch mode of presence	332
	Regional rural banks (64)	Limited area of operation	
	Local area banks (4)	Limited area of operation	
Cooperative Banks	Urban cooperative banks (1,606)	Multistate urban cooperative banks	43
		Single state urban cooperative banks	1,563
	Rural cooperatives (93,551)	Short term	92,834
		State cooperative banks	31
		District central cooperative banks	371
		Primary agriculture operative societies	92,432
		Long term	717
		State cooperative agriculture and rural development banks	20
		Primary cooperative agriculture and rural development banks	697
Microfinance Institutions	There are 52 microfinance institutions that have either received or applied for registration from the Reserve Bank of India as of June 2015. They constitute over 90% of total microfinance industry business in the country.	Arohan, Bandhan, BSS, Cashpor, Disha, Equitas, ESAF, Grama Vidiyal	10,553

Sources: RBI (2014a), MOF (2015a).

Table 2: Growth in Deposits and Credit in India's Banking System
(Rs billion, as of 31 March)

	1951	1961	1971	1981	1991	2001	2011	2014
Aggregate deposits (% of GDP)	8 (7.9)	17 (10)	59 (12.8)	380 (26.1)	1,925 (33.8)	9,629 (44.4)	52,080 (66.9)	85,331 (67.9)
Aggregate credit (% of GDP)	5 (5)	13 (7.7)	47 (10.1)	254 (17.5)	1,164 (20.4)	5,114 (23.6)	39,420 (50.6)	67,352 (52.8)
Branches				35,707	60,220	65,919	90,918	116,450
ATMs							74,505	160,055

GDP = gross domestic product.

Source: MOF (2015b).

Table 3: Market Share of Different Types of Banks in India
(%)

Bank Group	Deposits	Credit
State Bank of India and its associates	21.5	22.1
Nationalized banks	52.4	51.1
Foreign banks	4.3	4.8
Regional rural banks	2.9	2.5
Private sector banks	18.8	19.4
All scheduled commercial banks	100	100

Source: RBI (2015).

Traditionally, banks have not considered the poor to be a viable market. Most formal financial institutions are reluctant to serve them and MSMEs because of perceived high risks, high costs involved in small transactions, low relative profitability, and inability to provide the physical collateral usually required by such institutions (IMF 2004). In technical terms, problems of adverse selection and information asymmetries make it difficult for financial institutions to screen and to monitor credit decisions.

To address this market failure and to provide financial services to low-income clients, MFIs emerged, although their character has undergone a shift from the time that they commenced operations. The pioneer MFIs operated as nonprofit, nongovernment organizations with a strong social focus. They developed new credit techniques; instead of requiring collateral, they reduced risk through group guarantees, appraisals of household cash flow, and small initial loans to test clients.[3] Today, however, MFIs have changed from nongovernment organizations to nonbanking finance companies (NBFCs), and there has been a modification in how they raise finance. Once primarily donor-led, MFIs are now increasingly funded by banks and private and shareholder equity.

Currently, the regulated microfinance market in India has over 30 million clients, served by nearly 50 regulated institutions with a gross loan portfolio of about $7 billion, reflecting growth of 61% over 2013–14 (MicroMeter 2015). The 10 largest MFIs account for 75% of the total industry loans. MFIs have a network of 10,553 branches, with 80,097 employees across 32 states and union territories. MFI activity is only set to grow, especially because only 8% of adults have loans from formal financial institutions. Only 35% have bank accounts, of which more than half are inactive or semi-active (World Bank 2015).

3. STATE OF FINANCIAL INCLUSION

India's record of financial inclusion, despite the existence of a large and well-regulated financial system dominated by commercial banks, is poor. Judging by aggregate macro data, the household debt–GDP ratio of 8.9% is among the lowest in the region, contrasted with the People's Republic of China at 36.8% and Thailand at around 83.0%.[4] The absence of inclusion is especially conspicuous in rural India, home to around 60% of the population. In 2013–14, deposits per head were only Rs9,244 (about $154) in rural areas, with credit about Rs6,000 (about $100) per head (Table 4).

[3] Experience has shown that the poor repay uncollateralized loans reliably and are willing to pay the full cost of providing them; access is more important to them than cost.

[4] Citi Research

That said, there are sections of the urban population (e.g., migrant labor) who do not have access to the formal financial sector as well.

Table 4: Per Capita Deposits and Credit in Rural and Urban India
(Rs)

	Rural		Urban	
Fiscal Year	Deposits	Credit	Deposits	Credit
2007–08	3,735	3,977	85,003	60,405
2008–09	4,441	3,779	100,146	71,437
2009–10	5,088	4,662	113,747	81,313
2010–11	5,924	4,713	131,303	98,772
2011–12	6,830	5,269	144,138	114,185
2012–13	7,923	6,197	162,145	127,854
2013–14	9,244	6,161	178,942	143,718

Source: Author estimates based on the data from RBI. Data Releases. https://www.rbi.org.in/Scripts/Statistics.aspx statistical database; and World Bank. World Development Indicators. http://data.worldbank.org/data-catalog/world-development-indicators.

Another manifestation of the lack of inclusion is the inadequate number of bank branches. The number of branches per 100,000 people in the rural segment is roughly one-third of that in urban areas (Table 5).

Table 5: Number of Branches of Banks in Rural and Urban Centers
(per 100,000 population)

Fiscal Year	Rural	Urban
2007–08	3.79	13.05
2008–09	3.84	13.65
2009–10	3.93	14.49
2010–11	4.08	15.28
2011–12	4.35	16.22
2012–13	4.70	16.99
2013–14	5.25	17.91

Source: Author estimates based on the data from RBI. Data Releases. https://www.rbi.org.in/Scripts/Statistics.aspx statistical database; and World Bank. World Development Indicators. http://data.worldbank.org/data-catalog/world-development-indicators.

A similar urban bias is seen in access to banking transaction points, such as ATMs (Table 6).

Table 6: ATM Penetration in Various Rural and Urban Centers
(per 100,000 population)

Time	Rural	Urban
December 2013	2.1	30.9
December 2014	3.3	36.1
March 2015	3.7	36.5

Source: Author estimates based on the data from RBI. Data Releases. https://www.rbi.org.in/Scripts/Statistics.aspx statistical database; and World Bank. World Development Indicators. http://data.worldbank.org/data-catalog/world-development-indicators.

The International Monetary Fund Financial Access Survey, which compared access to financial services across countries, reinforced this exclusionary narrative for India. The survey showed that while India has made remarkable progress in terms of financial deepening and widening, a large percentage of the population lacks access to basic financial services. Table 7 shows there are only 13.3 ATMs per 100,000 adults in India, the lowest in the sample. Similarly, at 12.2 commercial branches per 100,000 adults, it is lowest in the group, with the exception of Indonesia. In deposit accounts, India has, however, performed better than others; the number of accounts has increased from 611.0 per 1,000 adults in 2005 to 1,197.6 in 2013.

Table 7: Financial Access in Selected Countries

Country	**Year**	**ATMs** (per 100,000 adults)	**ATMs** (per 1,000 kilometers)	**Commercial Bank Branches** (per 100,000 adults)	**Commercial Bank Branches** (per 1,000 kilometers)	**Deposit Accounts with Commercial Banks** (per 1,000 adults)	**Loan Accounts with Commercial Banks** (per 1,000 adults)
India	2005	2.3	5.9	9.0	23.2	611.00	101.0
	2013	13.3	39.0	12.2	35.7	1,197.60	147.0
Brazil	2005	108.9	17.4			705.70	
	2013	130.7	23.2	47.7	8.4	1,153.50	
China, People's Republic of	2005						
	2013	46.9	55.7	7.8	9.3	40.40	
Indonesia	2005	9.4	7.7	5.3	4.4	508.60	139.7
	2013	42.4	39.8	10.4	9.8	863.00	217.0
Sri Lanka	2005			8.9	20.9		
	2013	16.7	40.5	18.6	45.1		
France	2005	92.9	87.3	22.0	20.7		
	2013	109.2	107.0	38.7	38.0		
United Kingdom	2005	117.9	240.9	28.4	58.0		145.0
	2012	126.8	273.4	22.2	47.9		113.7

Source: IMF. Financial Access Survey. http://data.imf.org/?sk=E5DCAB7E-A5CA-4892-A6EA-598B5463A34C

India's impressive performance in deposit account uptake is primarily due to the government's initiative to transfer national employment guarantee wages directly to the worker. In 2009, the government mandated that the transfer of wages under the Mahatma Gandhi National Rural Employment Guarantee Act (MNREGA) be made directly to the bank accounts of the workers. The objective was twofold: to reduce leakages, and to widen the access to basic banking services.[5] However, the number of loans with commercial banks remains low, indicating that most of these accounts are used merely for receiving wages.

Another survey conducted by the World Bank captured how adults save, borrow, make payments, and manage risk (Table 8). The data showed that despite vigorous promotion of the use of electronic modes of payment over paper-based payments, the former is still at a nascent stage in India. Only 2.0% of people surveyed said that they use electronic methods for payment. Further, while 22.4% people saved money, only 11.6% did so at a formal financial institution.

[5] The MGNREGA is a law whereby any adult who applies for employment in rural areas must be given work on local public works within 15 days. If employment is not given, an unemployment allowance must be paid. Mahatma Gandhi National Rural Employment Guarantee Act. http://www.mgnrega.co.in/

Table 8: World Bank's Global Findex

	India	Brazil	China, People's Republic of	Indonesia	Sri Lanka	France	United Kingdom
Payments							
Check used to make payments	6.7	6.7	1.8	1.5	2.8	79.5	50.1
Electronic payment used to make payments	2.0	16.6	6.9	3.1	0.5	65.1	65.3
Mobile phone used to pay bills	2.2	1.3	1.3	0.2	2.4		
Loan in the past year							
Loan from a financial institution	7.7	6.3	7.3	8.5	17.7	18.6	11.8
Loan from a financial institution, income, bottom 40%	7.9	3.5	7.7	6.4	19.1	16.1	11.1
Loan from a financial institution, income, top 60%	7.5	8.2	7.0	10.1	16.5	20.3	13.2
Insurance							
Personally paid for health insurance	6.8	7.6	47.2	0.9	7.5		
Purchased agriculture insurance (% working in agriculture)	6.6	11.2	7.2	0.0	8.1		
Savings in the past year							
Saved at a financial institution	11.6	10.3	32.1	15.3	28.1	49.5	43.8
Saved at a financial institution, bottom 40%	10.4	5.8	18.3	7.8	19.0	37.7	43.5
Saved at a financial institution, income, top 60%	12.9	13.3	41.7	20.8	36.4	57.0	44.3
Saved any money in the past year	22.4	21.1	38.4	40.5	36.3	61.8	56.7
Saved any money, income, bottom 40%	19.4	12.1	23.3	31.9	24.1	51.0	56.2
Saved any money, income, top 60%	25.8	27.1	48.9	46.8	47.4	68.6	57.7

Source: World Bank (2014).

Against this background, it is useful to identify the needs of financially excluded households: a basic savings account with overdraft facilities, an instrument for remittances that plugs into the nationwide electronic funds transfer network, a pure savings instrument with relatively high returns and a lock-in period, and credit. A recent initiative toward these goals has been the Pradhan Mantri Jan Dhan Yojana (PMJDY), an ambitious plan that seeks to cover each household in India with a bank account.[6] Over 190 million Jan Dhan accounts were operational in October 2015.[7] In fact, on the first day of the program, 15 million bank accounts were opened. Account holders are given a debit and a credit card, while microinsurance is likely to be added later. It is

[6] The PMJDY has six pillars: (i) universal access to banking facilities; (ii) provision of a basic bank account with overdraft, and a RuPay debit card to all households; (iii) encouragement of financial literacy to enable use of financial products; (iv) a credit guarantee fund to mitigate risks stemming from overdraft facilities extended to these accounts; (v) provision of microinsurance for all account holders; and (vi) unorganized sector pension schemes, such as Swavalamban Yojana.

[7] Pradhan Mantri Jan Dhan Yojana. http://www.pmjdy.gov.in/account-statistics-country.aspx

envisaged that after 6 months, account holders will be entitled to overdraft facilities as well.

The Reserve Bank of India (RBI) has also made an effort over the last decade to create basic financial service facilities for the excluded. In April 2005, it recognized that vast sections of the population did not have access to banking services due to minimum balance requirements. To achieve greater access, RBI counseled banks to open basic banking or "no-frills" accounts with no or very low minimum balances and no or minimal charges. Conceding the stigma associated with the nomenclature "no-frills," banks were advised to offer a "basic savings bank deposit account" (BSBDA) with simplified know-your-customer norms.[8]

Until March 2014, 243 million BSBDAs were on the books of banks, but the increase in the number of accounts is not reflected in a corresponding increase in the number of transactions (RBI 2014a). Table 9 shows that outstanding deposits in BSBDAs were only Rs312.3 billion, while overdraft used in these accounts was only Rs16.0 billion. Moreover, most of the MNREGA accounts are only used to receive wages; beneficiaries withdraw their money immediately after it is deposited, leaving very low balances in these accounts (RBI 2014a). Even in the PMJDY Jan Dhan accounts, many new bank accounts remain dormant, resulting in costs for banks and limited gain to the beneficiaries. According to one estimate, 80% of accounts opened do not have transactions, revealing that the account holders are still not really financially included (Patel 2014).

Table 9: Banking Penetration Progress, 2010–2014

	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Banking outlets in villages					
Branches	33,378	34,811	37,471	40,837	46,126
Business correspondents	34,174	80,802	141,136	221,341	337,678
Other modes	142	595	3,146	6,276	
Total	67,674	116,208	181,753	268,454	383,804
Urban locations through business correspondents	447	3,771	5,891	27,143	60,730
Basic savings bank deposit account branches					
No. in millions	60.19	73.13	81.20	100.80	126.00
Amount in Rs billion	44.33	57.89	109.87	164.69	273.30
Basic savings bank deposit account business correspondents					
No. in millions	13.27	31.63	57.30	81.27	116.90
Amount in Rs billion	10.69	18.23	10.54	18.22	39.00
Overdraft availed in basic savings bank deposit accounts					
No. in millions	0.18	0.61	2.71	3.92	5.90
Amount in Rs billion	0.10	0.26	1.08	1.55	16.00
Kisan credit cards (No. in millions)	24.31	27.11	30.24	33.79	39.90

Source: RBI 2014.

[8] There are three basic requirement for BSBDAs: (i) all credits in a financial year cannot exceed Rs100,000; (ii) withdrawals and transfers per month cannot exceed Rs10,000; and (iii) balances at any point cannot exceed Rs50,000.

The inference is that bundling of government welfare payments into BSBDAs through direct cash transfers is only necessary for ensuring that the accounts are used. There is a need to customize products and services that are relevant to account holders; until then, the poor will open accounts only because it is mandatory to do so.

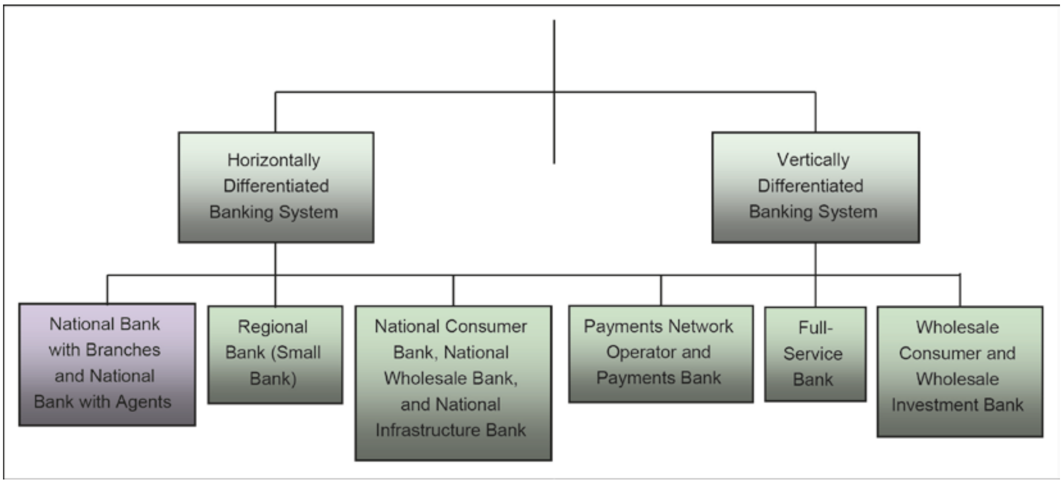
4. DELIVERY MODELS, REGULATIONS, AND OTHER ISSUES

4.1 The Mor Committee

A comprehensive blueprint for the architecture of inclusion was created by the Mor Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households in 2014. This committee proposed the following to be achieved by 1 January 2016: (i) provision to each resident over age 18 years of an individual, full-service electronic bank account; (ii) establishment of widely distributed electronic payment access points, offering deposit and withdrawal facilities at reasonable cost; (iii) provision to each low-income household of convenient access to formally regulated providers that can provide suitable credit products, investment and deposit products, and insurance and risk management products at reasonable prices; and (iv) provision to every customer of the legally protected right to be offered suitable financial services.

One criticism of the recommendations was that the targets and timelines set by the committee were aggressive. RBI identified 490,000 villages, and allotted them to various banks for coverage by 2016. This entailed that these banks open 80,000 additional rural branches during 2013–2016. Only 7,459 rural branches were, however, opened. The committee's recommendations were also skewed toward payments and deposit creation, and inadequate in ensuring improved credit delivery or risk products to the poor.

Figure 1: Present Financial Architecture and Banking System Design



The Mor Committee did recognize that an optimally designed banking system for India must involve a mix of horizontally differentiated and vertically differentiated banking systems (Figure 1). Banking systems across the world are based on these two designs: (i) horizontally differentiated, in which the basic design element remains a full-service bank that combines the three building blocks of payments, deposits, and credit but is differentiated primarily on size, geography, or sector; and (ii) vertically differentiated, in which the full-service bank is replaced by banks that specialize in one or more of the building blocks of payments, deposits, and credit (i.e., a functional design configuration).

4.2 Small Banks

Globally, small banks have been seen as a crucial link in the process of financial inclusion. This belief has led to the creation of a range of structures in India's financial system, such as regional rural banks, united community banks, and local area banks. These are locally governed and funded out of the local deposit base. As per RBI data, as of 2012–13, the total number of regional rural bank offices stood above 17,000, with about 75% located in rural areas. They were created in the mid-1970s and 1980s largely on the back of regulatory advantage of lower capital adequacy norms as subsidiaries of sponsor commercial banks. Yet by the end of 1990s, most turned out to be unviable. The number of regional rural banks has dwindled from 196 to 62 over the years (Subbarao 2013). Further, only four of six local area banks in India, licensed by RBI, are functioning, with the rest shut down primarily due to mismanagement.

Global evidence regarding the performance of small banks is mixed. Small banks in developing countries (e.g., Ghana and Nigeria) have solvency problems. The United States model is also beginning to develop cracks, mainly due to the failure of such banks to keep pace with the advancement in banking technology (RBI 2014b). Regional banks in Germany and Switzerland, on the other hand, are backed by an effective risk management structure and have thus been able to survive.

Although small banks do possess certain benefits in the form of low-cost, customized services per local needs and near absence of contagion effects, they are vulnerable to capture and concentration risk, owing to localization of their operations and political influence (RBI 2014b). There are other risks of commodity price volatility and weather vagaries, which create the need for a high capital adequacy ratio. Moreover, small banks cannot experience economies of scale, as they are expected to operate within specified limits. They also lack the capacity to finance big projects.

Smallness or localization does not present a strong case for their creation based on regulatory forbearance. The licensing of new banks should instead be driven by the level playing field principle, and if a local NBFC or other candidate for a license has the financial strength or eligibility, it should be given a license. Indeed, 8 of the 10 entities granted a license for small finance banks by RBI recently are MFIs.[9] The key reason to convert into a small finance bank is access to deposits; they will also be able to offer a wider range of loan products to customers. The converted companies must follow the pricing structure of banks, which is linked to their base rate.

4.3 Microfinance Institutions

MFIs who did not receive a small bank license or did not apply also remain integral to the objective of inclusion. After a turbulent year in 2010, the microfinance industry in India has undergone some significant changes in regulations and operations.[10] The crisis of 2010 stemmed from extremely high and often usurious interest rates, coercive

[9] Disha Microfin, Equitas Holdings, ESAF Microfinance and Investments, Janalakshmi Financial Services, RGVN (North East) Microfinance, Suryoday Micro Finance, Ujjivan Financial Services, and Utkarsh Micro Finance. RBI (2015).

[10] See Shylendra (2006) for an account of the crisis.

debt collection practices, and multiple lending. All three problems related to the interface between the borrower and MFI. In 2011, RBI mandated clear communication of lending rates, tenure of loans, repayment flexibility, and the need to create a customer redress mechanism. MFIs have retained their priority sector lending status, while RBI has recently introduced self-regulatory initiatives such as the Industry Code of Conduct and development of a credit bureau toward responsible microfinance.

The industry bodies of MFIs, the MicroFinance Institutions Network (MFIN) and Sa-Dhan, are now recognized as self-regulated organizations by the central bank.[11] It is not yet clear if they will report to RBI or the newly created Micro Units Development and Refinance Agency (MUDRA) Bank. [12] Self-regulation is tricky and does not imply discretionary regulation; it is simply a model of regulatory outsourcing that obliges the organization to monitor members and to ensure compliance with the extant regulations of the central bank, including responsible lending. Self-regulated organizations are required to formulate a code of conduct and have an effective grievance redress system for borrowers and a dispute resolution structure for members. In the current framework, MFIs can report to Sa-Dhan or MFIN, which is not necessarily good for regulatory efficiency. Moreover, such competition could result in regulatory arbitrage, since, in practice, some MFIs could be members of both Sa-Dhan and MFIN.[13]

An area where self-regulated organizations could be immediately effective is in aligning interest charges of members with their costs. This would lead to price differentials across NBFCs that would both exert downward pressure on interest charges and lead to greater operating efficiency in the system. While the more efficient may see a temporary drop in margins, it would benefit them in the long term. Less-efficient companies would see a loss in business volume, while the fitter should see their losses in margins offset by a rise in volume.

4.4 Business Correspondents

Another significant regulatory change toward financial inclusion has been the relaxing of norms for business correspondents or *bank mitras* (i.e., agents of the bank) to complement the classical approach of physical branch-led distribution. Business correspondents provide last-mile connectivity for financial services in remote and underbanked locations. While initially restrictive in the kind of players who can qualify as business correspondents, the norm has been significantly eased, as it is now open to profit-making entities.

Business correspondents are microbankers who are outside of the purview of regulators. They are "protected" by the capital of a sponsor bank, but since they do not provide any capital themselves, the moral hazard of risky lending becomes a distinct possibility. Banks in Brazil and India have been uncomfortable with allowing business

[11] In March 2015, Sa-Dhan, an association of MFIs, was accorded the status of a self-regulatory organization, which gave it powers to monitor MFIs and to ensure the lenders are in compliance with rules. Sa-Dhan is the second association to be given this status by the central bank; MFIN was given that status in 2014.

[12] MUDRA Bank was launched on 8 April 2015 to provide formal or institutional financial support to the noncorporate small business sector. The bank with an initial corpus of $3.5 billion is charged to provide access of formal systems of credit to the "bottom-of-the-pyramid" entrepreneurs, popularly known as the "missing middle."

[13] Since the model for the sector is new, however, it is too early to comment on the utility. It takes time for institutions to establish the desirable characteristics of independence and credibility; the test lies in actual behavior of the institution when faced with difficult decisions that involve substantial interest group conflict (Melody 1997).

correspondents to lend. There has been some effort to overcome this moral hazard problem, allowing business correspondents to hold capital against the loans that they sanction.[14] Given that financial viability remains an issue, it is still a question whether the business correspondent model can be scaled.

4.5 Payment System

A policy in India encouraging large financial institutions to customize products for low-income customers enjoyed only moderate success, triggering a review by RBI that led to the creation of new regulatory financial and architecture.[15] In 2015, RBI granted approval to set up 11 payment banks and 10 small finance banks (RBI 2015). Payment banks are permitted to accept demand deposits (i.e., current deposits) and savings bank deposits from individuals, small businesses, and other entities. They are restricted to holding a maximum balance of Rs100,000 per individual customer, and they cannot issue credit cards or undertake lending activities. Payment banks are permitted to set up outlets such as branches and ATMs, and to appoint business correspondents. Small finance banks will undertake basic banking activities, such as acceptance of deposits and lending to unserved and underserved sections, including small business units, small and marginal farmers, MSMEs, and unorganized sector entities.

A large informal sector and a vast pool of migrant workers means that a sizeable fraction of transactions in India, estimated at 65%, occur in cash (RBI 2009). Informal channels for cash transfers exist but are expensive and inefficient compared to electronic methods. Thus, a critical aim of the inclusion agenda is the provision of a robust payment system that minimizes the use of cash. This involves the convergence of banking, digitization, and mobile phones as invoked in the JAM Number Trinity solution (i.e., Jan Dhan Yojana, Aadhaar cards, and mobile numbers) proposed in the *Economic Survey 2014–15* that allows the state to transfer subsidies to poor households in a targeted manner.

While enhancing payment efficiency is the principal objective, products such as digital wallets can also function as savings instruments earning interest.[16] Yet although most scheduled commercial banks have the credentials and balance sheet strength to offer mobile-based financial products, the key question relates to the desirability of entry of nonbank participants into this space. Currently, 27 private participants (i.e., pre-paid instrument providers) are allowed to offer digital wallets up to Rs50,000 that must be backed by escrow deposits placed with a commercial bank. While expansion of this private network will help inclusion, there are potential risks. For any money transfer scheme, customer authentication becomes critical.[17] There is merit in converting pre-paid instrument providers to payment banks, as RBI has recently done, as mobile wallets gain the status of deposits and earn returns (RBI 2009).

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[14] ICICI Bank in 2005–06 successfully experimented with the concept of a credit franchisee, who is similar to a business correspondent or facilitator but was required to place a fixed deposit with the bank of 10% of the amount of loans that he or she would sanction. Upon default, the deposit would function as a first loss deficiency guarantee.

[15] For a brief analytic discussion, see NCAER (2011)

[16] The success of mobile wallets and fully digital banking in African economies (e.g., the M-PESA model in Kenya) is well documented. This mobile phone-based banking model has also been successfully transplanted to other markets, such as Afghanistan.

[17] News reports suggest that this risk has increased in countries such as Kenya and Tanzania, which have extensive mobile banking channels, forcing a review of their regulation and monitoring.

Further, Indian Post, with 155,000 outlets, has recently been awarded a payment-banking license. Apart from their core activities, they also provide financial services, such as savings schemes; issue cash certificates, money orders, and insurance; and sell mutual funds, pension products, and remittance services. With core activities being affected by competition from private players, the post office needs to reinvent itself. Given its long-standing reputation and deep network that has served many isolated areas, the post office is well situated to succeed in its new role.

4.6 Policies

An important instrument of financial inclusion in India has been the priority sector lending targets that mandate that all domestic commercial banks, public or private, lend 40% of their adjusted net bank credit or credit equivalent amount of their off-balance sheet exposure (whichever is higher) to priority sectors. For foreign banks with more than 20 branches, the corresponding figure is 32%. Further, public sector banks have clearly defined rules in the subcategories of agriculture, MSMEs, education, housing, and export credit. For example, 45% of all priority sector lending must be made to agriculture.[18] However, the economic objectives that underlie priority sector lending, although laudable, must be reinforced by robust implementation, including careful monitoring of distribution (Ramakumar and Chavan 2014). It is widely believed that the quality of execution has been weak; in many cases, the institutions have had to be recapitalized or amalgamated (MOF 2015b).

Another critical issue relates to interest rate regulation. The charge on all loans is currently linked to banks' base rate, except on farm loans, which is capped at 7%. Banks receive an interest subvention from the government of 2%, but a uniform cap often means that many loans are priced out of sync with their risk profiles. This needs to be removed. Accordingly, in April 2014, RBI removed the price cap of 26% on loans advanced by MFIs, the only lenders eligible to lend through the microfinance channel. The rate at which MFIs now advance loans is the lower of the margin spread over the cost of funds or the average base rate of the five largest commercial banks by assets multiplied by 2.75 (Vishwanathan 2014). This inclusion agenda can succeed in the long term only if banks view it as a viable business model. They also must be allowed to price risk freely.

Interest rates, on the other hand, can be brought down on a sustainable, commercially viable basis through greater competition in the system, as shown by international experience. The Consultative Group to Assist the Poor examined the experience of 30 countries and found that interest rate ceilings impeded the penetration of microcredit (Helms and Reille 2004).

The stability of the new financial system depends on the ability to gauge and monitor the risk associated with borrowers. It is imperative to link all transactions, but particularly for small loans like self-help group loans or kisan (i.e., small farmer) credit cards to credit bureaus. At a broader level, a data-sharing arrangement among telecommunications operators, electric utilities, and credit bureaus can provide a detailed risk matrix for the economy.

Proportionality in regulation is also vital, that is, a policy and regulatory framework that is proportionate with the risks and benefits involved. A proportionate approach requires the regulator to understand the risks presented by a specific type of institution, activity, product, or service; and to design regulation and supervision so the costs to the

[18] According to latest figures from the Central Statistical Office, agriculture constitutes 14% of GDP and supports over 48% of livelihoods in India.

regulator, institutions, and consumers are proportionate to the risks being addressed, taking into consideration the anticipated benefits as well. A proportionate approach is critical to avoiding overly burdensome regulation and supervision that may inhibit new entrants and innovations, including those that could beneficially serve people who currently do not have access to financial services (Lauer and Tarazi 2012).

4.7 Suitability and Financial Literacy

Another goal that the Mor Committee emphasized is the right to suitability. Suitability means that every customer (e.g., a household or a small firm) has the right to be sold a suitable product in keeping with the risk and income profile. This right, not to be "missold" a financial service by a financial institution, is the most difficult to implement.

The new customer protection rules of the Financial Sector Legislation Regulation Reforms Commission stipulate clearly defined processes for monitoring suitability and penal action for violation. Both the commission and the Mor Committee recommended the creation of a unified financial redress agency for customer grievance redress across all financial products and services, which will, in turn, coordinate with the respective regulator.

More stringent customer protection laws alone are unlikely to achieve financial inclusion. This must be complemented by a significant increase in financial literacy.[19] In 2013, India ranked the lowest in financial literacy among 16 countries in the Asia-Pacific region, based on a survey of 7,756 respondents aged 16–64 years (MasterCard 2015). To help improve financial literacy, some banks have set up literacy centers that work with microfinance organizations. The Citi Center for Financial Literacy, in Ahmedabad, has an outreach of 500,000 stakeholders, a significant number for an individual bank but tiny in relation to the entire population of the underbanked. RBI has also launched a financial literacy project among the target groups of schoolchildren, senior citizens, and military personnel. In its school-level initiative, RBI personnel use an interactive module to teach the fundamental concepts of financial literacy. It has also been suggested that financial literacy be included in the school curriculum. Stand-alone financial literacy drives, similar to many other awareness campaigns, are likely to have only limited success.

The extensive penetration of mobile telephones makes them a potent platform for promoting financial literacy. Media experts have suggested that games and competitions built around a financial literacy theme can be disseminated through the telecommunications network. Financial literacy modules can also be shown along with television programs and films; for this objective, rural India has many traveling cinemas.

5. MICRO, SMALL, AND MEDIUM-SIZED ENTERPRISES

It is well recognized that MSMEs[20] are large contributors to the national GDP and provide meaningful employment to over 100 million workers (MMSME 2014). It is also well established that the credit needs of these enterprises have been largely ignored by

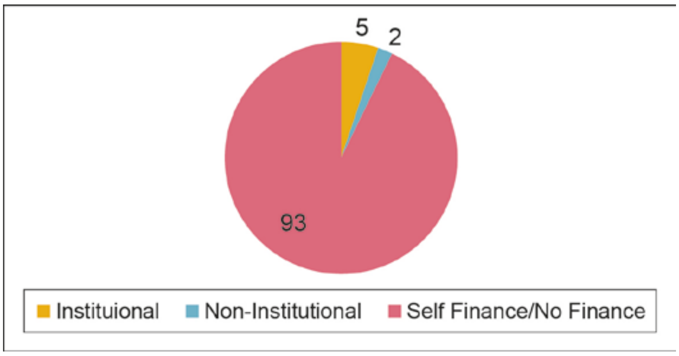
[19] The concept of financial literacy must encompass understanding of both financial products and services, as well as the basic and advanced operations of the banking system. For instance, customers in rural areas are not well equipped to deal with advanced biometric systems. In fact, most of them do not even possess the basic knowledge of opening a deposit account.

[20] Development Commissioner, Ministry of Micro, Small and Medium Enterprises, Government of India. What Are Micro, Small & Medium Enterprises? http://www.dcmsme.gov.in/ssiindia/defination_msme.htm

the formal financial system. The sector employs an estimated 59.7 million persons spread over 26.1 million enterprises. In terms of value, it accounts for about 45% of the manufacturing output and around 40% of the total export of the country, next only to the agriculture sector. The survey showed that only 5.18% of the units (both registered and unregistered) received finance from institutional sources, 2.05% had finance from noninstitutional sources, and the majority (92.77%) had no finance or depended on self-finance. This has also partly to do with inadequate penetration of banking facilities in the remote areas that RBI is encouraging banks to bridge through structured financial inclusion plans. Alternative sources of finance, such as risk or venture capital, are scarce; thus, these enterprises have to fall back on debt from informal institutional sources, often at extremely high interest rates.

Figure 2: Financial Exclusion in the Micro, Small, and Medium-Sized Enterprise Sector

(%)



Source: Chakrabarty (2013)

The survey also revealed that the few who borrow from banks do so at prohibitively high costs, 13%–15%. The lack of formal finance for these units is often driven by the perception that they constitute poor-quality credit and that their loan impairment ratio is high (Chakrabarty 2013). However, adjusting for write-offs and restructuring, micro and small enterprises actually fare better than their larger counterparts (Table 10).

Table 10: Impaired Assets Ratio

(%)

Segment	March 2009	March 2010	March 2011	March 2012	March 2013
Micro and Small	10.7	10.6	9.4	9.7	10.6
Medium and Large	7.8	9.4	8	11.2	14.8

Impaired assets ratio = (gross nonperforming assets + restructured standard advances + cumulative write-off) to (total advances + cumulative write-off.)

Source: Chakrabarty (2013).

Some of the constraints faced by MSMEs will be met by the greater penetration of banking itself either through physical branches, information and communications technology-based branches, or business correspondents. These, however, must be combined with aggregate credit targets specified by the Prime Minister's Task Force on MSMEs that stipulated 20% credit growth to micro and small enterprises on a year-on-year basis. Banks have also been directed to follow a cluster-based approach to MSMEs to ensure that banks develop specialized industry expertise in their lending while reducing their transaction costs (GOI 2010). RBI has also directed banks to open more specialized branches for MSMEs and to simplify credit approval processes.

There is also a serious dearth of equity capital, a major impediment for first-generation entrepreneurs who need equity financing for start-up ventures. This has been partly addressed by the dedicated platforms set up for MSMEs by the National Stock Exchange of India and Bombay Stock Exchange. Listings on these two exchanges have started to increase since mid-2013. The Bombay Stock Exchange platform has 90 firms listed on it, but the listings on the National Stock Exchange of India have been much lower. Indeed, the numbers of firms operating on both exchanges are small given the size of the sector.[21]

MSMEs are particularly vulnerable to considerable delay in settlement of dues and payment of bills by large-scale buyers. This has to be institutionally tackled by factoring, and banks should provide such services, particularly to MSMEs. To facilitate factoring services, the government passed the Factoring Regulation Act in 2011, which addresses delays in payment and liquidity problems of MSMEs. Factoring provides liquidity to MSMEs against their receivables from customers, and is regarded as a cash management tool. Factors are entitled to take legal recourse for recovering assigned debt and receivables from buyers of goods and services. Despite the institution of a legal framework, factoring is yet to take off in a significant manner, due to lack of credit insurance, lack of clarity on stamp duty waivers by states, and lack of access to debt-recovery platforms. All of these issues need to be resolved as part of the financial inclusion initiative.

Banks also have a vital role to play in nurturing the sector, and this cannot cease with the provision of credit. Banks and other financial institutions must view themselves not just as providers of credit but as partners in the growth of these enterprises, by aiding first-generation entrepreneurs. Typically, MSMEs operate with low productivity of capital and have either too little or too much cash. The tools for this work are fully developed (e.g., cash-flow forecasts and cash-flow management). The financial management needs of MSMEs are predictable, and banks, by providing these services, can reap enormous rewards in terms of fee-income, enhancing business volumes, and boosting the credit quality of these firms.

Speedy disbursal of loans to MSMEs is contingent on the efficiency of the appraisal process. An important dimension to efficiency in the context of lending decisions is the speed with which any individual lending decision is taken. Efficiency is improved by better evaluation of future payment performance, so that the lender is able to choose whom to accept. RBI recommended that a credit-scoring approach typical for large-volume consumer loans be used, instead of a more elaborate credit-rating approach.

The newly formed MUDRA Bank has a key role in catalyzing fund flows to MSMEs. MUDRA Bank aims to meet the credit needs of the unfunded categories, broadly defined as self-employed or own-account enterprises. Borrowers in these MSMEs generally lack standardized documents and do not have the collateral that formal sector financial institutions seek. This market segment is large, almost entirely in the unorganized sector, and vulnerable to a range of economic shocks. The primary purpose of the bank is refinancing for lending to MSMEs. It is also envisaged to perform regulatory functions for all types of entities in the microfinance space.

[21] Issue sizes on the exchanges have ranged from Rs50 million to Rs250 million.

Experience in India has shown that incorporating regulation and financing functions within a single institution can be challenging. As RBI currently oversees the activities of MFIs, dual oversight and the attendant risk of regulatory arbitrage are a possibility. In the aftermath of the 2010 crisis, RBI facilitated the development of a well-articulated framework for governance, including a revival of investor confidence. At present, MFIs that represent over 90% of the microfinance industry are supervised by the central bank.

6. CONCLUSION

To address the market failure to provide financial services to low-income clients, India has a huge opportunity. For the first time in the last decade, financial inclusion is at the heart of the policy agenda, and it has been widened to include savings, credit, insurance, and pensions. Technology increasingly affords the opportunity to improve delivery; in particular, there are technologies that enable better targeting and transfer of financial resources to households.

Today, India has several strategic assets providing favorable conditions for change-leveraging technology. A strong banking network of 115,000 branches linked to ekuber (i.e., RBI's core banking solution) is spreading into rural areas that lack banks. Indian Post, with 155,000 outlets, has a payment-banking license, and point-of-sale networks and ATMs facilitate cash transactions across the country. India’s vibrant network of almost 1 billion mobile connections, covering 75% of the population, can facilitate the spread of banking services through the business correspondent model and also enable funds transfer over mobile phones. Moreover, Aadhaar, the national identification system that seeks to cover the entire population by 2016, can provide backend verification and the security architecture.

MFIs have also emerged as important players in the inclusion space, successfully revitalized after the 2010 crisis due to regulatory intervention and candid introspection following the severe public censure (Sane and Thomas 2013). Clients are now offered services with clear communication of lending rates, tenure of loans, and repayment flexibility. Complementing these regulatory directions, there have been many self-regulatory initiatives aimed at promoting responsible business practices in the microfinance market. RBI has also raised its lending limits for MFIs that will allow them to serve a wider section of borrowers.

The new architecture of inclusion reflects the failure of the traditional formal sector and the need to adopt modern methods to serve the poor. In this context, regulation has a fundamental role to play in ensuring that market-oriented solutions to poverty alleviation coexist with other social initiatives. India’s financial inclusion agenda has seen a welcome shift away from an emphasis on credit to a more comprehensive approach.

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