POLICY BRIEF ON FINANCIAL INCLUSION IN INDIA
1. Models to enable universal inclusion

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This is the first of five policy briefs to study the intricacies of expanding financial inclusion

- Employing mobile operators as business correspondents to banks is the best means to achieving universal inclusion due to cost considerations and market penetration
- Many issues need sorting, such as the coordination between TRAI and RBI, interoperability, ensuring private sector participation, revenue sharing etc.

Executive Summary

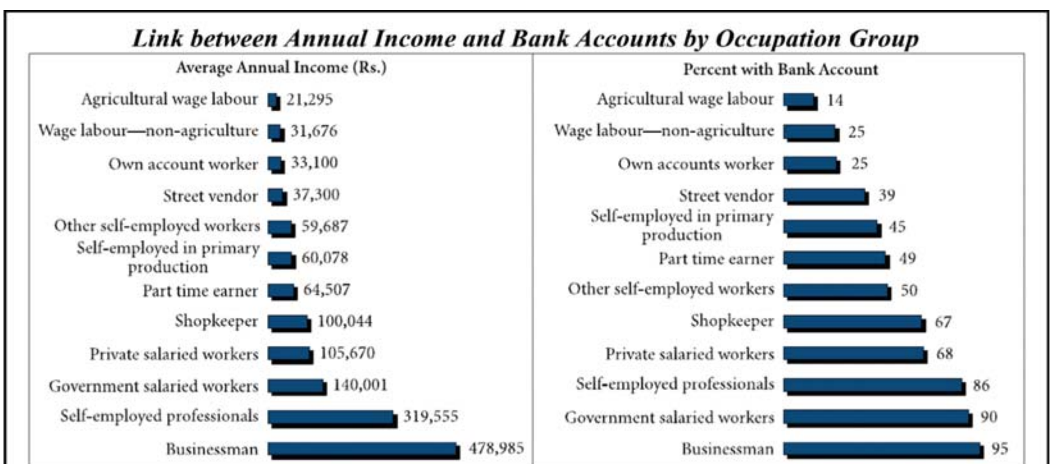
Sustaining the development of the country will require current levels of growth to trickle down to the poorest and more excluded of society. A critical way to extend these benefits will be to bring people into the formal sector of finance, whereby they may have more reliable and cheaper access to their financial needs of remittances, savings, borrowings etc. Many models have been suggested as alternatives to traditional branch banking, the current penetration of which is abysmally low. Options include mobile banking, enlisting business correspondents, encouraging MFIs, etc., and each option has its strengths and weaknesses. The models with the greatest potential for the future should be able to leverage on existing retail networks and the rapidly expanding ICT (information and communication technology) platform. As such, the BC model, clubbed with m-banking technology, holds the greatest promise to achieving universal inclusion and steps must be taken to encourage its sustained proliferation.

THE PROBLEM

Which approaches might be optimal to achieve universal inclusion in India, and what are the regulatory changes required for enabling the same?

BACKGROUND

While India has been growing at a scorching pace for the better part of a decade now, 700 million people have been unable to reap the benefits of growth and continue to live in deprivation. Sustaining the country's growth requires the benefits to trickle down to the bottom of the pyramid. For this section to develop, a critically needed instrument is access to credit, so as to finance people's day to day livelihoods, businesses, etc. However, only 27% of all rural households and only 3% of the unregistered small scale units have access to formal sector credit. Worse still, only 45% of India's adults have access to bank accounts, with a strong correlation between income levels and access to accounts. Clearly much needs to be done to promote financial literacy and bring people under the net of the formal financial system.Link between Annual Income and Bank Accounts by Occupation Group



Source: IISS, 2007.

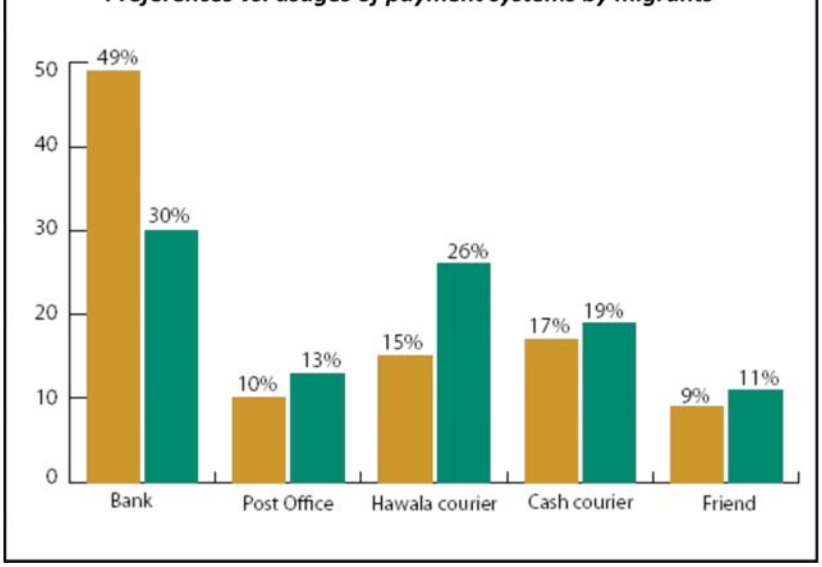
Financial inclusion is a key policy goal because it allows people to transact through reliable bank accounts as opposed to unreliable informal channels. It records their transaction histories and allows them to avail credit at far lower rates than they would otherwise accept (moneylenders often set interest rates in excess of 50%). It cuts into money laundering, tax evasion and fraud, and increases efficiency. More people can partake in social welfare schemes due to significant government savings on the administrative costs of delivering the same.

EXISTING POLICIES

Although micro-finance institutions (MFIs) and self-help group (SHG) models have been in existence for about four decades, policymakers have only recently adopted financial inclusion as a goal and the regulatory space has witnessed a flurry of activity only in the past 5-6 years.

One important step taken by the RBI was its 2005 directive to banks to issue no frills accounts, which can allow for zero account balances, minimal transaction charges and relaxed Know your customer (KYC) norms. This is a costly proposition for banks, which stand to lose on every such account issued. The government is currently mulling a subsidy of INR 140 for each such account, the number of which currently stands at 50 million.

Further, to enable remittances through formal channels, a sender doesn't need an account to transfer money, so long as the receiver has an account that the money is being remitted to; a helpful policy move for migrants who frequently live in rented accommodation and cannot furnish proofs to fulfill KYC requirements.



Preferences vs. usages of payment systems by migrants

Business correspondents (BCs) were allowed to enter the financial inclusion space in 2006, to serve as last mile infrastructure for banks. Regulations governing their entry were progressively relaxed till in September 2010, every company listed under the Company Act, barring NBFCs, was allowed to engage as a BC.

In 2007, the passing of the Payments and Settlement Systems Act provided for the regulation and supervision of all payment systems such as card-based and m-platform ones, and designated the RBI as the authority for that purpose.

More recently, in 2008 the RBI issued operative guidelines on m-banking and amended the same in 2009 to ease limits on transaction sizes and address security concerns.

Despite the host of regulations, financial inclusion is a relatively new concept and policies are continuously evolving. The RBI and government's pursuit of universal inclusion can be gauged from the various committees they've constituted to recommend changes to financial regulations. Examples include the Khan Committee (2005) on rural credit, the Rangarajan Committee (2008), Malegam Committee (2010) on MFIs, the Inter-Ministerial Group (2009) on mobile financial services, etc. These committees have come up with recommendations pertaining to regulation/deregulation of various models of inclusion, all with views to increase coverage.

MODELS OF EXPANDING FINANCIAL INCLUSION

The various means to achieve universal inclusion all have distinct features. However, two or more of them can be jointly implemented so long as there is a coordinated policy behind them. Some of these means are now discussed.

BANK BRANCHES/ATMS

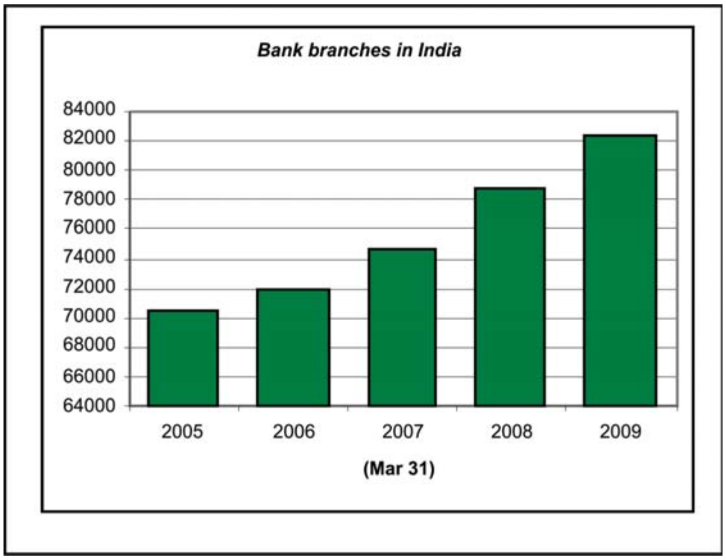
The most obvious and preferred means to extend financial coverage so far has been to increase the spread of bank branches and ATMs. India currently has about 80,000 bank branches, across 630 districts and a land area of 3.2 million square kilometers, for a density of one branch per every 45 square km. This is not even close to adequate.

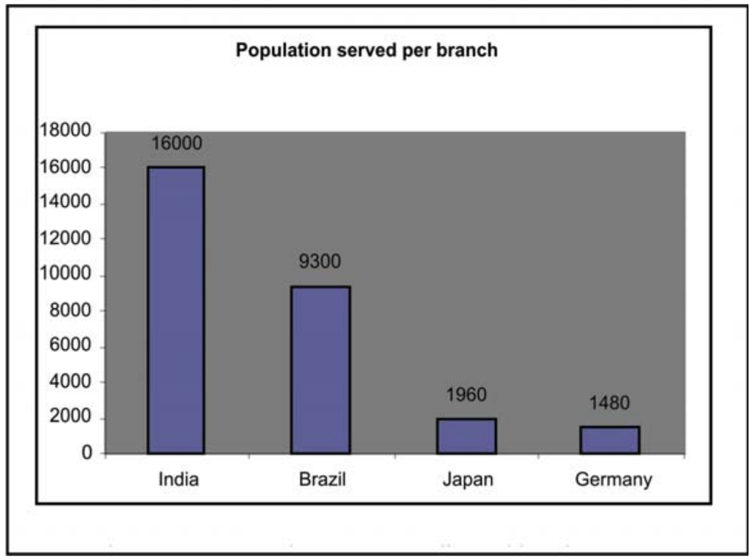
The advantages of increasing the reach of banks are:

- They fall under the RBI's regulation and can be more easily monitored and directed to pursue inclusion as a goal
- The trust factor for banks is high amongst the user population

However, this model of advancing inclusion does have some glaring disadvantages:

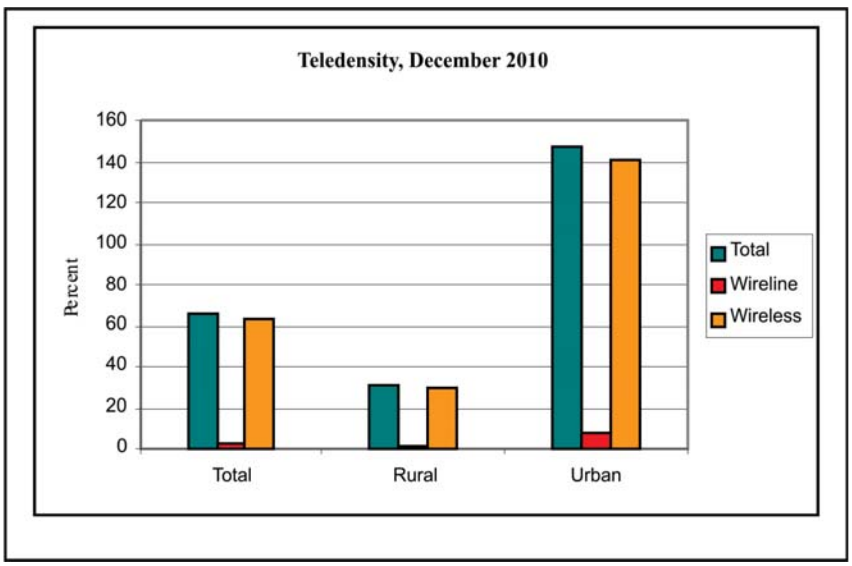
- It is the most costly to set up in terms of infrastructure requirements
- ATMs are not practical amongst a large population with high levels of illiteracy
- It is a loss-making proposition for those branches in the most backward districts which are required to collect low-value deposits, and thus they are lacking in incentives to promote inclusion





BUSINESS CORRESPONDENTS

Since 2006, banks have been able to enlist the services of BCs to act as the 'last mile infrastructure', and the regulations surrounding this model have evolved with its development. Crucially, mobile networks can now be tapped by banks and financial service providers to provide an electronic platform to make payments, transfer money and even use as a deposit/credit facility.



Advantages of the BC model are:

- BCs such as kirana stores, gas stations, PCOs, etc are present in every corner of India
- Regulations have been progressively relaxed, regarding the eligibility of participation as well as the location constraints vis-à-vis bank branches
- Mobile network operators (MNOs) already have a huge subscriber base that it would be easy to cover
- The model doesn't require significant investments in infrastructure
- Mobile tariffs in India are amongst the lowest in the world; MNOs would be glad of the chance to boost revenues through M-banking services while customers would still be able to afford the transaction charges

Disadvantages:

- The profit-making objective of participants could conflict with the social inclusion policies being promoted
- It will require substantial time and effort to train the retail vendors to provide the desired services
- Concerns about agents' authority to open accounts, conduct KYC checks etc. will have to be addressed
- Mobile Value Added Services are not widespread in India, and form only 10% of the revenues of MNOs

- Regulations have to be drafted to ensure interoperability among MNOs, at least once agent networks are in place
- M-banking will require joint regulatory oversight by RBI and TRAI

UIDAI

The Unique Identification Authority of India is an ambitious government venture that aims to provide a unique ID to each of India's 1.2 billion people, not necessarily with the issuance of an ID card, and so obtain a record of all the citizens. Its advantages are:

- The scheme is already in motion, is sanctioned by relevant authorities, and is already issuing 100,000 cards a day
- The 3-tiered identification will be free of charge and won't require KYC compliance, thereby simplifying the task
- It will allow the linking of multiple accounts, as well as utilities, consumer behavior, etc
- The single centralized server to hold the database will prevent duplication

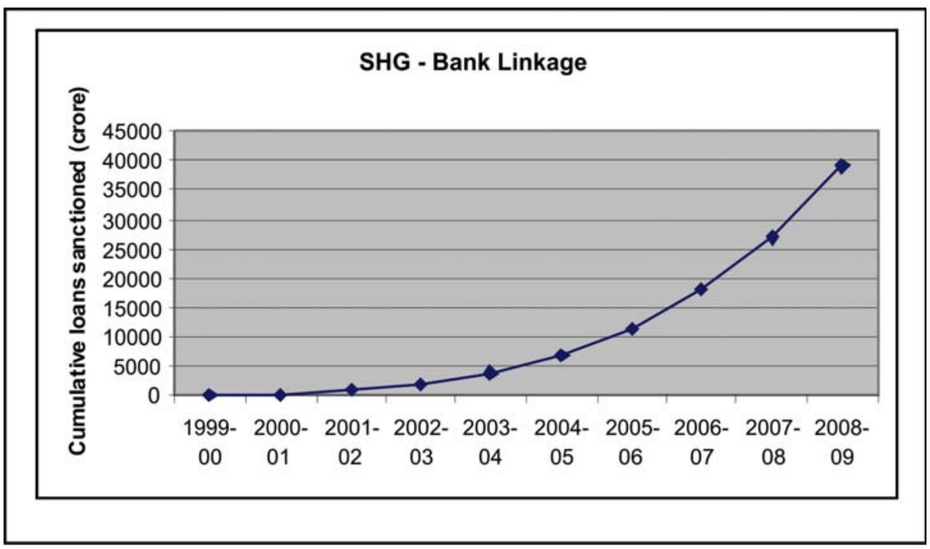
Disadvantages

- There is as of now no clear strategy on extending the ID to each person
- It is not a vehicle for financial inclusion itself, merely a tool to obtain records of every person

SHGS AND MFIS

Micro-finance has been one of the oldest ideas to promote universal inclusion and has been around in the country for about four decades now. It has achieved a measure of success, mainly due to the following reasons:

- The peer review system that encourages fiscal responsibility
- Community lending that fosters trust
- The theoretical lack of incentives to fleece customers on the part of cooperatives



But the model has not been able to scale up, for the following reasons:

- MFIs, except those registered as NBFCs, are currently not regulated by any authority, and their unregulated malpractices have led to problems such as farmer suicides in Andhra Pradesh
- They are mainly focused on credit delivery, not on deposits. Deposits can only be accepted by the small proportion of NBFC-MFIs that come under the purview of the RBI
- Their reach is limited, and they are more concentrated in South India

RECOMMENDATIONS

While the UID scheme ambitiously aims to bring everyone under a common database, it is at best a supplement to other means of achieving inclusion. The MFI/SHG model will be useful in local disbursement of credit, but scaling up of this model seems unlikely. The best option for promoting universal inclusion then is branchless banking, either through BCs or through m-banking or ideally a mix of both. The cost savings and high potential for rural penetration justify a strong focus on these means.

The requirement then is to iron out the wrinkles with this approach, which is beset with thorny issues as is so often the case when two prominent sectors are brought into close contact. Key issues to tackle will include

- sorting out an equitable revenue-sharing model
- increasing participation of private sector banks
- preventing anti-competitive practices and cartelization
- providing proper regulatory oversight