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Perspectives on Financial Inclusion: Rakesh Mohan[12]
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A policy paper on the intricacies of expanding financial inclusion

I Introduction

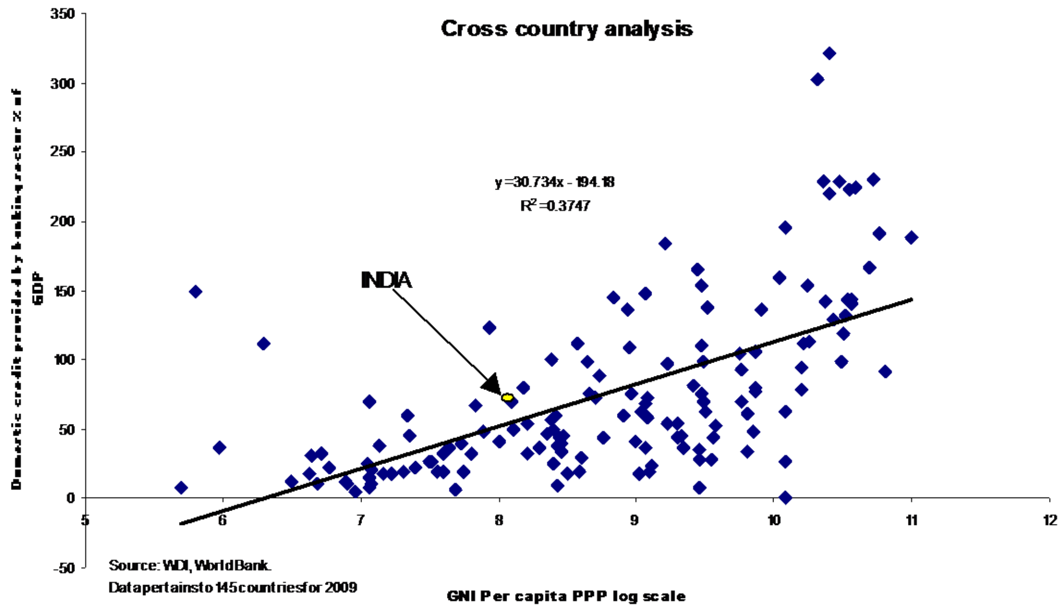
The Indian economy has seen accelerated growth over the past decade; more importantly, there are concrete signs of sustainability along with financial stability, notwithstanding the pressures from unforeseen external shocks, such as the recent global crisis. However, despite this successful transition to a higher growth path, inclusive growth remains a concern and on the top of the agenda for government policy.

The key point brought out in this paper is that the state of financial inclusion in India is not as straightforward as it is usually made out to be, the evidence on financial inclusion is mixed and the situation is not as poor as has been asserted in recent analyses. There appears to be relatively healthy access to secure formal facilities for savings, but access to credit in rural areas has not grown as might be expected. In particular, resort to informal sources for credit has increased for emergency and consumption purposes. Seen from this perspective, measures taken for achieving universal financial inclusion must be fine tuned to these ground realities.

II Conundrum: Is India really under banked?

The key question that will frame strategy towards universal financial inclusion is whether India is really under banked. The answer is less clear than is usually posited. No doubt our financial depth is much lower than that in other Asian countries, but countries that are usually used in such comparisons have per capita incomes that are substantially higher than India's. So although it is true that, as measured by the various conventional metrics of financial depth such as bank credit to the private sector, or total bank assets as a proportion of GDP, Indian financial penetration is low even in comparison to other EMEs, it is perhaps better to place such metrics in the context of per capita GDP. As may be seen from the graph, given India's comparatively low GDP, its financial penetration is above the trend line. Thus, whereas it is essential that continuous efforts are made to extend the reach of the Indian banking system, it is perhaps not correct to assume that the Indian population is under banked, in relation to its current income levels.

Also, there has been a rapid increase in financial depth in India over the past decade, along with rising incomes. Thus, as income growth takes place and Indian income levels approach current ASEAN levels, financial depth will not only be comparable to their current levels, but is likely to be much higher if current trends continue.



There is an additional point when making an assessment of financial inclusion in India. As only about half of all savings accounts are with commercial banks, it is important to take account of all the institutions that serve rural areas, from primary agriculture credit societies to post offices. So it turns out that for the country as a whole, there were as many as 82 accounts per 100 adults in 2007. If we observe that at least 20 per cent of the Indian population is below the poverty line, they would, by definition not have any savings to put in a bank. This estimate has been corroborated by the NCAER/Max New York Life survey, which found that about 20 per cent of the households did not have any savings[3]. Thus, if the people below the poverty line are excluded, 'it is estimated that there are about 105 accounts per 100 adults'[4]. Thus access to formal financial institutions in India cannot be described as particularly poor even after accounting for multiple accounts in higher income households.

Looking back, it is true that there was a slowdown in banking activities over the 1990s, which seems to have led to some reversal in the expansion of formal banking activities in that decade relative to the rapid expansion experienced in the 1970s and 1980s. The 1990s was a time when, as a result of enhanced prudential regulation and stricter supervision, banks were busy cleaning up their balance sheets and their credit expansion to SSIs and to agriculture slowed down. It was also during this period that many public sector banks were listed, and their managements got much more focused on their bottom lines. The consequence was slippage in the coverage of the less well-off, particularly in rural areas. As the balance sheets became healthy by 2002–3, they began to lend for these activities again and also responded to government exhortation after 2004. After recovery in the 2000s, the data do not suggest that India is substantially under banked. Thus, relatively speaking, and contrary to popular impression it is difficult to conclude that India is particularly under banked.

III Financial inclusion concerns

Then why is there continued widespread concern, as in the Rajan Committee[5] report? There are essentially two issues here that stand out to be addressed – over-dependence on informal finance and relatively low deposit growth in rural areas.

a) Over-dependence on informal finance: Some of the recent concerns on financial inclusion have emanated from the results of the All-India Debt and Investment Survey (AIDIS), 2002. The share of non-institutional sources of credit for rural households had declined sharply from about 93 per cent in 1951 to about 36 per cent in 1991, with the share of money lenders down from 71.6 per cent to 16.9 per cent. AIDIS (2002) data revealed that the share of money lenders had again increased to 29.6 per cent, while that of non-institutional sources overall rose to 42.9 per cent. Notwithstanding the outreach of banking, these data suggest that the formal credit system has not been able to penetrate the informal financial markets adequately; rather it would seem to have shrunk in some respects in recent years.

Given that India is not particularly under banked, why is there large recourse to informal sources of credit? First, whereas national averages may be encouraging there is huge regional diversity. The lower income regions of the country—central, eastern, and north-eastern—are poorly served. Second, a good proportion of non-formal borrowing is by the less well-off for consumption needs, medical and other emergencies, marriages and deaths, and for education. More than 60 percent of loans taken from non-institutional sources were for those purposes, which the formal financial sector would not provide for. At lower income and asset holding levels the availability of collateral is scarce, and cash flow is minimal, making it difficult for institutional sources to extend consumption related loans or for emergencies. So, lower the income, more the recourse to family, friends and money lenders to finance immediate financial needs.

However, it is important to point out here that while their lack of credit worthiness is due to low incomes and lack of collateral, high debt is being incurred to meet needs that should have been served by public services, particularly in health and education. In other words, the same poor households would be better-off and possibly credit worthy if they were not forced to spend money on basic essentials that are supplied by the government in most other countries. It is difficult to see how the formal institutional sector can serve these needs in a prudent fashion. What the poor need is probably better public services, income generation and welfare rather than greater indebtedness, which could then drive them into further poverty. The recent events related to excessive indebtedness of poor households to micro finance institutions illustrates this point, a point that cannot be emphasised enough. The financial sector cannot substitute for failures of the government in delivery of essential public services.

b) Changing rural economy: Evidence suggests that deposit mobilization has not kept up with the kind of income and other changes underway in rural areas. Non-agriculture activities now account for at least half of income generation in rural areas, clearly monetisation is proceeding apace there. There has been a marked decline in the share of

cereals and pulses in total production (agriculture and allied) from 38.4 per cent in 1960-61 to 25.4 per cent in 2007-08. On the other hand, the share of other segments such as livestock and fishing, and non-cereals has been recording a significant increase. There has been a silent revolution over the last 20 years, unnoticed by many researchers and policy makers alike. The value of output of non cereal vegetarian food and of non-vegetarian food (livestock and fishing) is each higher than that of cereals. In principle, these activities should be more credit intensive. It is, therefore, of the utmost importance that our image of what is agriculture, changes from that of simple rice and wheat to a more complex structure, so that policy makers can assign due importance to the sector and respond accordingly. Such an appreciation would help in re-orienting banking activities in rural areas toward a more appropriate composition of credit, and hence financial inclusion that reflects the emerging composition of economic activity, both agricultural and non agricultural.

IV Financial inclusion calls for going beyond banking

The previous sections brought out the characteristics of the Indian economy that call for a more holistic strategy to financial inclusion, than mere overall deposit and credit growth. For one, there is the need to design appropriate financial services. Lack of suitable services/products leaves the rural poor with little option but to transact with the informal sector, which accepts small amounts, provides doorstep service, makes available funds for all purposes (productive and non-productive such as consumption needs, festivals, marriages, medical and emergencies) and ensures ease of operations. Financial institutions, therefore, need to design tailor-made thrift, credit, insurance and remittance products for the poor and weaker sections taking into consideration their requirements and repayment capacity. Apart from savings and loan products, poor people also need insurance products. Health related expenditure at times far exceeds the income levels of many households, which can lead them to a debt trap. The insurance companies, therefore, also need to design low cost health insurance products for the rural poor. The viability of such low cost insurance has been demonstrated in a number of pilot programmes in the country, e.g. in Karnataka. The need is also felt for weather insurance products to provide relief to farmers in cases of losses due to excess/ deficient rainfall but this is difficult to design and implement in an actuarially sustainable manner.

Further, supporting infrastructure is crucial to achieving financial inclusion. The credit absorptive capacity of the currently financially excluded would depend not just upon income, but also other factors such as appropriate policy environment, coupled with infrastructure and supply chain facilities. Here the government has an important role in building adequate infrastructure such as roads, electricity, public transport and marketing facilities that would facilitate production and distribution of output by the people residing in rural and remote areas. As noted earlier, government expenditure on social services such as health, education, water and sanitation would also enhance the credit absorptive capacity of borrowers as they relieve households from these expenditures that they currently have to incur. A large proportion of borrowings by low income households takes place for medical and other emergencies. Thus, borrowings from non-institutional sources could be reduced to a significant extent if health care, education and other services are provided to rural households at reasonable cost, including appropriate

medical insurance at a reasonable premium. The government, therefore, has a crucial role in facilitating financial inclusion by strengthening the rural infrastructure and providing enabling conditions.

V Conclusion

Financial inclusion is an important policy objective for India, with the RBI bringing in several measures to help in extending coverage of financial services. This paper highlights the fact that the state of financial inclusion in India is not as straightforward as it is usually made out to be. Looking at financial penetration in line with its level of per capita income, India is relatively better off than expected. Moreover, taking into account all financial institutions including PACs, post offices etc, the access to formal financial institutions in India cannot be described as particularly poor even after accounting for multiple accounts in higher income households.

Two issues that are crucial to consider while framing strategy are the over-dependence on informal finance, particularly for consumption needs, medical and other emergencies, education etc., and the changing structure of the rural economy. Looking at the causes behind over-dependence on informal sources, the solutions lie in creating better public facilities for health and education, as well as supportive infrastructure to raise income generation opportunities. Rather than expect banks to step in for these credit needs, it is important to raise the credit worthiness of the poor through other programmes and services; without such measures, indebtedness is bound to increase and the recent events related to excessive indebtedness of poor households to micro finance institutions emphasises the ill effects of such a strategy very clearly. When it comes to the rural economy, though, it is true that deposit mobilization has not kept up with the kind of income and other changes underway in rural areas. While non-agriculture activities now account for at least half of income generation in rural areas, it is crucial that the perception of the agricultural sector changes from just basic food grain production to a more complex structure, so that policy makers can assign due importance to the sector and respond accordingly. Banking activities in rural areas should be reoriented towards a more appropriate composition of credit, that is towards financial inclusion that reflects the emerging composition of economic activity. In addition, it is also important to look at methods of reducing costs incurred by lenders when serving rural communities by setting up credit information bureaus, developing risk assessment techniques, adopting new technologies and utilizing business facilitators and correspondents to increase outreach.

To sum, it is important to put financial inclusion in the correct perspective, to ensure that the strategy to achieving the goal is correctly targeted. This calls for appropriate strategies from banks, financial institutions and the government. While aiming for universal financial inclusion, care must be taken to ensure that the needs of the communities and the formal financial system are well balanced. In effect, understanding that India is not particularly under-banked should take the focus away from mere opening of bank accounts towards an appreciation of the crucial changes that are vital on the ground to ensure universal financial inclusion.

[1] Rakesh Mohan served as Deputy Governor of the Reserve Bank of India during the periods 2002-04 and 2005-09 and is currently Professor in the Practice of International Economics of Finance, School of Management, and Senior Fellow, Jackson Institute of Global Affairs, Yale University.
[2] This paper draws on work previously done by the author. See Chapter 6 in Rakesh Mohan, ***Growth with Financial Stability: Central Banking in an Emerging Market.*** New Delhi: Oxford University Press, 2011
[3] According to the Tendulkar Committee of the Planning Commission, the new estimate of poverty in India is 37.2 percent in 2004-05.
[4] RBI 2008
[5] *Report of the Committee on Financial Sector Reforms* Chairman: Raghuram Rajan. New Delhi: Sage Publications. 2009