Expanding financial inclusion through social transfers: A sustainable model

Policy Brief July 2013

Key Takeaways

India has chosen a bank-led model for financial inclusion and the recent thrust for government social transfers through this route augurs well for inclusion, while raising some practical concerns for banks and the agents in meeting the mandate. This policy brief focuses narrowly on one of the many concerns: the need for incentivizing the banks and agents to ensure sustainable viability.

- Studies on countries that have made the transition from social transfers in cash to electronic payments show that the business case for banks in this segment depends crucially on government fees; at least in the short term, revenue from the float or cross-selling is not sufficient. India still has to satisfactorily settle this issue for viability at the last mile.
- An effective government incentive structure supports both bank and agents, is time-bound and fine-tuned to the needs of diverse geographic and socio-economic segments within a country. For instance, higher commissions are warranted in rural areas, where agents face significant challenges.
- Alternate modes like mobile wallets and payment cards can be integrated into the government payment system. Such low cost options should be explored in India, with appropriate regulation, to stimulate competition and innovation while providing faster coverage in specially challenging segments.

Executive Summary

Over the last eight years, India has chosen a bank-led model to spread inclusion, through a network of business correspondents. While there have been significant achievements in setting up the supporting infrastructure and policy, there are many challenges to be overcome (RBI, 2013). The mandate given to the banks weighs heavily on the system, as they grapple with the need to set up sustainable business models. Given the mandate is a public service, the government can play a large role in incentivizing this expansion, to aid the move into areas that have been commercially unattractive so far. International experiences documented in this brief show that digitizing social transfers is an extremely effective way to bring the unbanked into the formal financial system. The current push through the Direct Benefits Transfer programme is therefore a welcome step in this direction. However, studies on countries that have made the transition from cash transfers to electronic payments show that overall a business case for banks in this segment depends crucially on government fees (Bold et al, CGAP, 2012); at least in the short term, revenue from the float or cross-selling is not sufficient.

The international experiences highlighted in this brief suggest that given the current Indian policy of using government transfers through a bank-led model for inclusion, designing appropriate government incentives for banks and agents is a necessary first step to sustainably expanding coverage amongst the unbanked. Government incentives should be designed to support banks/agents though the initial phase, while the onus is shifted gradually but completely on them to innovate products to the local needs. These incentives should cater to the heterogeneity of communities, both geographically as well as socially, and this increases the challenges in a country like India. Therefore, a consultative approach and flexibility in these structures are crucial.

In India, currently, experiences of rollouts in some districts as well as studies on banking agents have pointed out this issue as a key weakness for the long term (Syed et al, MicroSave, 2013 and India Banking Agents Survey, 2012). Not only do agents have to negotiate with the banks at each step, agents at the last mile do not get sufficient income in rural areas especially (Platt and Tiwari, MicroSave, 2012) and the problem is also acute for the banks that bear the costs of setting up the channels. In February 2012, the Task Force headed by Nandan Nilekani had, after consultations with stakeholders, recommended compensation at 3.14%, which is in line with international benchmarks. However, though the DBT has been rolled out in some areas, there is still little clarity amongst banks and agents on the exact details of the incentives proposed to be paid (See Note[1]).

While this brief has taken up the issue of incentives for viability in India's chosen bank-led model for social transfers, there are other alternative modes that have the potential to expand inclusion at a lower cost. Mobile wallets and payment cards can be used to reach out to segments at a significantly lower cost, using already existing networks. Such options circumvent the high costs in the banking system and introduce the unbanked to electronic transactions. Provision of alternative channels will stimulate innovation in delivery and appropriate products and services. The mission of providing affordable access to financial services amongst the unbanked is a huge challenge in India. It is for our policy makers to use all possible modes and measures, with suitable regulation and supervision, such that, at the very first step, at least all Indians are linked to the digital pathway.

Background

Over the last eight years, India has chosen a bank-led model to spread inclusion through a network of business correspondents. While there have been significant achievements in setting up the supporting infrastructure and policy, there are many challenges to be overcome. For instance, banking presence spread over a little more than two lakh villages over the past three years (RBI, 2013); however, though coverage now stands at 2.68 lakh villages out of India's six lakh villages, even in these areas inactive new accounts are the norm. The mandate given to the banks weighs heavily on the system, as they grapple with the need to set up sustainable business models. Given the mandate is a public service, the government can play a large role in incentivizing this expansion, to aid banks and agents spread into areas that have been commercially unattractive so far.

To begin with, the potential of using government payments to lead the unbanked into a more active role in the formal financial system has been well documented (Pickens, Porteous and Rotman, CGAP, 2009). The recent push by the government through the nationwide Direct Benefits Transfer scheme announced in November 2012 is in line with this trend worldwide and aims at accelerating the process of inclusion. Though there are many challenges in rolling out such a programme nationwide (Chopra, MicroSave, 2013), this policy brief focuses narrowly on just one of these issues – the need to put in adequate incentives for a sustainable business model for banks and agents.

Studies on countries that have made the transition of from social transfers in cash to electronic payments show that overall a business case for banks in this segment depends crucially on government fees (Bold et al, CGAP, 2012); at least in the short term, revenue from the float or cross-selling is not sufficient. Two other important components of a sustainable business model here are the use of a widespread and effective agent network (branches and ATMs proving more costly in remote areas) and access to a mainstream financial account that will allow for higher volumes of business over time.

The Experience of Colombia

The experience of Colombia (CGAP, 2013) can be particularly instructive to India at this juncture, though the scale of operations is quite different. In 2006, the government planned to spread the conditional cash transfer programme through a payments channel across all 1100 municipalities, when a little over a quarter of these had no banks. A year after allowing banks to set up an agent network, the results showed

1. Note: The current proposal given in April 2013 of 1% commission, moving to 2% on software upgradation, falls short of benchmarks set by the Task Force. http://www.finmin.nic.in/the_ministry/dept_expenditure/plan_finance2/DBTScheme09042013.pdf

that agents were mostly present in urban areas and largely inactive. In order to achieve greater coverage in the shortest possible time, over the next three years three sets of tenders were put out to give direct incentives to banks to cover the population. The process of designing the tenders went through several consultations with the stakeholders and each proposal was designed specifically with the characteristics of the population being served (See Box 1). Incentives were temporary and decreased over time to motivate the bank towards making each agent profitable over the long run.

Box 1 Designing incentives for agent networks in Colombia

A Invitation to Tender I : 128 agents in 128 municipalities with fewer than 50,000 inhabitants. The incentive guaranteed a minimum number of transactions over a specific period at a set price so that the bank would break-even. In the first year, the government paid the difference between the transactions made and those guaranteed at 100% of the price, at 50% the second year, and at 0% the third year. The bank was committed to keeping the agent open until the end of the third year.

B Invitation to Tender II: Remaining 67 municipalities after the first tender process. The same system of guaranteeing transactions was used, but as these municipalities were smaller and more remote, the minimum number of guaranteed transactions was increased, and incentives decreased progressively, but at a slower rate over four years.

C Invitation to Tender III—Expanded coverage to marginal neighborhoods in five major cities. This incentive co-financed the cost of establishing agents, including costs of installations, operations, and staff. The types of transactions permitted by the bank were also defined. Co-financing would gradually decrease throughout a period of three years: 50% the first year, 25% the second, and 0% the third.

Source: Incentives for the Introduction of Agents by Banca de las Oportunidades in Colombia, CGAP, February 2013, available at http://cgap.org/sites/default/files/colombia_agent_subsidy_english.pdf

Though many concerns do remain to be sorted out, the basic aims of coverage and increasing access and usage of financial services are being achieved. By 2013, 99% of the municipalities had access to financial services, activity by other banks, finance companies and cooperatives have spurted in earlier unattractive areas and transactions in the savings accounts have increased.

DBT in India and the case for compensation

It is quite clear that reaching the unserved rural population and reducing costs of delivering social transfers are both crucial elements for public welfare programmes. The question of who should take on the cost of building the requisite financial infrastructure remains key to the challenges of a sustainable and effective business model. India has chosen the bank-led model for inclusion with targets given to the banks for expanding coverage through agents under the Financial Inclusion Plan gradually over the years. The Direct Benefits Transfers scheme has now brought a sense of urgency to bring the beneficiaries into the banking system, and when it comes to some schemes like the LPG subsidy, the numbers involved and geographic coverage are large enough to pose challenges to the entire system. However, while putting in place the structures for direct payments into bank accounts and micro-ATMs, it is crucial to keep in mind the issue of commercial sustainability till the last mile.

Experiences of rollouts in some districts have pointed out this problem. For example, the case study of the Aadhaar-enabled DBT programme in Aurangabad district (Syed et al, MicroSave, 2013) brought out several best practices for other districts to emulate, yet noted a key weakness i.e. "the business case for the bank, the BCNM and their agents is not viable with the current compensation metrics." Commission on the transfers by state governments through the BC channel range from 0 to 2%, and as agents have to negotiate with the banks for their share, at the last mile the CSPs do not get sufficient income in rural areas especially (Platt and Tiwari, MicroSave, 2012).

The Task Force headed by Nandan Nilekani had examined this issue and suggested compensation for making the government transfers viable at the last mile (See Box 2). This is in line with international benchmarks; in Pakistan for instance, a 3% commission is given to banks under the Benazir Income Support Programme (CGAP, January 2013). Over the last year, however, there has been little clarity on the exact details of the incentives proposed under the DBT (See Note1). This makes planning difficult even in the short term, while banks and agents struggle to meet the targets set by the government.

Box 2: Recommendation of Task Force on an Aadhaar-Enabled Unified Payment Infrastructure

In order to make Government payments viable at the last mile, and recognizing the fact that many of these accounts will offer little or no float, this Task Force suggests that the Government bear a last-mile transaction processing fee of 3.14% with a cap of

Rs.20 per transaction. For interoperable transactions, 31% of the fee can be paid to the issuing bank, 64% to the acquiring bank, and 5% to the switch. This fee is benchmarked against other offerings with similar characteristics: India Post charges a 5% fee for money orders, while mobile operators started with a 16% agent commission for top-up ten years back, which has now stabilized at 3.5% on average.

Source: Report of the Task Force on an Aadhaar-Enabled Unified Payment Infrastructure, February 2012, Available at http://finmin.nic.in/reports/ Report_Task_Force_Aadhaar_ PaymentInfra.pdf

The way forward

The international experiences highlighted in this brief suggest that given the current Indian policy of using government transfers through a bank-led model for inclusion, designing appropriate incentives for banks and agents is a necessary first step to sustainably expanding coverage amongst the unbanked. Incentives should be designed to support banks/agents though the initial phase while the onus is shifted gradually but completely on them to innovate products to the local needs. Ideally, these incentive structures should cater to the heterogeneity of communities, both geographically as well as socially, and this increases the challenges in a country like India. Therefore, a consultative approach and flexibility in these structures are crucial for effective and universal coverage.

While subsidies are a short term solution to kick-start the inclusion process, the basic problems in an agent model however cannot be solved with incentives alone. For instance, designing appropriate products and services and adequate liquidity are key to increasing usage of the formal system. Therefore, while subsidies can of course help lower perceptions of risk and strengthen the business case for banks, in the long term a strong agent network requires high transaction volumes typical of a truly financially inclusive model.

Also, the Colombian experience shows that while the agent model is preferred to a branch or an ATM, it still may not be appropriate for very small or remote municipalities. In certain areas, a truly low-cost channel would be mobile banking, provided there is adequate tele-connectivity and cash-in and cash-out points that guarantee functionality. It is for this reason that models such as Kenya have worked: agents prefund their own float so that they do not use a line of credit from a bank, bank risk is limited and appropriate regulation insulates payment risks from intermediation.

To conclude, while this brief has taken up the issue of viability in India's chosen bank-led model for social transfers, there are other alternative modes that have the potential to expand coverage at a lower cost and introduce the unbanked to digital transactions. For instance, mobile wallets and payment cards[1] can be used to reach out to segments at a significantly lower cost, using already existing retail networks. Provision of alternative channels will stimulate innovation in delivery and appropriate products and services. The mission of providing affordable access to financial services amongst the unbanked is a huge challenge in India. It is for our regulators and policy makers to use all possible modes and measures, with suitable regulation and supervision, such that, at the very first step, at least all Indians are linked to the digital pathway.

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1. The United States uses the Direct Express Master Card to access around 4 million social transfer beneficiaries, who do not have bank accounts. In Pakistan, Easy Paisa, owned and managed by Telenor Pakistan and Tameer Microfinance Bank, disburses government pensions and cash transfers.

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The support of 'Bill and Melinda Gates Foundation' is gratefully acknowledged.