

Beyond Micro Finance: Strategic Shift to Financial Inclusion to Stimulate the Growth of Rural India

Shalini Talwar

Associate Professor, Sinhgad Institute Business Management, Mumbai

ABSTRACT

Poverty, malnutrition, poor standard of living and various other growth-related issues continue to plague India. This becomes even more shocking when seen in the context of the spectacular transformation of Indian economy over past decade. Despite the recent financial crisis, India has witnessed a growth rate of around 8-9% a year. But this impressive growth story hides within its fold the reality that vast majority of Indians continue to struggle for the daily bread and are deprived of even the most basic necessities.

It is universally recognized that poverty in India stems largely from lack of inclusive growth caused by exclusion of nearly 51 % people from basic financial services.

Over the years, a substantial microfinance system based on self-help groups has evolved in India to alleviate poverty. But, its success is marred by problems of high interest rates, exploitative profit making and regulatory issues. It is now being realized that microfinance, is a short-term solution to financial problems that can be resolved only through access to the entire gamut of finance solutions.

The author recommends that the regulators and policy makers should draw lessons from the international experience in order to ensure that financial reach goes beyond a meaningless number crunching. Increasing financial inclusion requires a multi-dimensional strategy that has empowerment, participation, private enterprise, policy thrust and local commitment as its corner stones.

Keywords – Financial inclusion, micro finance, poverty alleviation, RBI, SHG

I. INTRODUCTION

Even after more than sixty years of independence, the basic issues facing the nation have not changed. Poverty, malnutrition, poor standard of living and various other growth-related issues continue to plague India. Though the parameters for measuring poverty have changed over the years: from the conventional criterion of subsistence level of living and lack of adequate food to a more wider definition in terms of lack of assets, unemployment and/or underemployment, low remuneration, lack of bargaining power, economic vulnerability, illiteracy, proneness to disease, lack of basic infrastructural facilities, social disadvantage and political powerlessness; the number of people living below poverty line continues to be appallingly high.

The Tendulkar Committee report (2009) held that 37 per cent of people in India live below the poverty line on the basis of the new way of defining poverty which is not based on just access to food, but also includes expenditure on health and education. Two other reports

have pegged poverty at higher levels: According to the Arjun Sengupta report (2007), 77 per cent of Indians live on less than Rs 20 a day while according to N C Saxena Committee report (2009), 50 per cent of people live below poverty. According to a new Oxford University study (2010), 55 percent of India's population of 1.1 billion, or 645 million people, are living in poverty. Using a newly developed index {Multidimensional Poverty Index (MPI)}, the study found that about one-third of the world's poor live in India.

The above statistics are even more shocking when seen in the context of the spectacular transformation of Indian economy over past decade. The country has witnessed historic progress and growth since liberalization of economy in early nineties. Despite the recent financial crisis, India has witnessed a growth rate of around 8-9% a year, much ahead of many developed countries of the world. According to a recent study, India is world's 12th largest economy and fourth in

terms of purchasing power parity. There are twice as many millionaires in India than in Japan and Germany, second only to US. But this impressive growth story hides within its fold the reality that vast majority of Indians continue to struggle for the daily bread and are deprived of even the most basic amenities and health facilities.

Though there is no consensus on the count of poor people in India, it is universally recognized that poverty in India and the development woes of the rural people stem largely from lack of inclusive growth, leading to inequalities in opportunities that prevent poor people from benefitting from the tremendous growth that the country is witnessing. This isolation from the fruits of growth can be attributed almost solely to the fact that nearly 51 % of our population is excluded from the basic financial services such as savings bank account and credit facilities.

II. GROWTH OF MICRO FINANCE TO ALLEVIATE POVERTY

1970s saw the growth of micro finance as a tool to alleviate poverty and ensure development of poor masses. In South Asia, Microfinance movement originated in Bangladesh as a means of financial upliftment of the poor population, living largely in rural areas. Success of the concept led to its adoption by a number of countries, including India. Over the years, a substantial micro finance system based on self-help groups has evolved in India. *SHG program, based on the philosophy of peer pressure and group savings as collateral substitute, has been successful in meeting the typical financing needs of rural poor and has led to their empowerment.*

This model has been very successful because many people in rural India don't have access to loans from formal sources. Even those who have access cannot borrow because the procedures are cumbersome and paperwork is never-ending. Microfinance institutions have provided an alternative to the local moneylenders and their exploitative terms. *The size of microfinance market has grown from merely \$12 million in 2003, to more than \$7 billion now and analysts expect this to grow to a staggering \$50 billion soon.* The coverage and outreach of microfinance is also tremendous. Women's self-help groups (SHGs) reach about 50 million people; another 20 million are covered by microfinance institutions (MFIs).

What is heartening is the fact that despite extreme social nuances, microfinance has moved out of the purview of development institutions and is now being embraced by private sector, as it is an extremely profitable business. The profitability is attributed to the

fact that compared to returns on government bonds of 6-7%, MFI lending provides returns of 10-14%. Further, microfinance lending, in its current form, is not very risky. MFIs usually lend through referrals, leading to repayment rates of 95% or more. It is not surprising then that microlending has seen massive expansion in recent times.

ICICI Bank, the largest private bank in India, had 1.2 million microfinance clients in 2005 and a portfolio of \$227 million. In little more than a year, ICICI had 3 million clients, targeting 25million more in years to come. Other banks, such as ABN Amro, Citibank, YES Bank and others have also joined the fray; operating on a partnership model. Public sector banks are also very active in microfinance and they operate as integrated micro-lenders, creating self-help groups (SHG) to which they disburse loans directly rather than through an intermediary.

So why the heightened decibel of chorus for a move beyond microfinance?

The answer to this lies in the model of microfinance itself. High interest rates, allure of profits and regulatory issues have been cited as some of the main objections against microfinance (Figure 1). At a more fundamental level, there is a rising concern about mismatch between *Credit* and *Deposit* Growth. It is also being realized that micro finance, through micro lending is a short term solution to financial problems. Any long-term solution to growth issues lies in full and complete inclusion of masses in the financial sector, giving them access to the entire gamut of finance solutions.

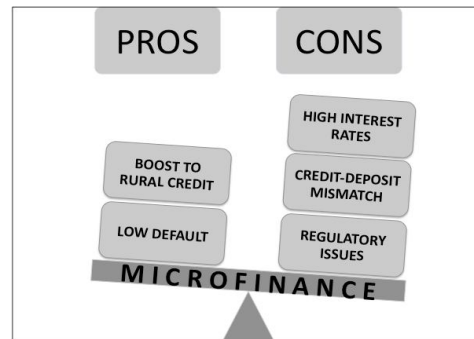


Fig. 1: A look at Microfinance

Source: Developed by the Author

As World Bank Policy paper on finance said: "One of the criticisms against the microcredit movement has been the focus on credit. Most MFIs do not offer savings services beyond the compulsory savings linked to credit. However, the fact that the poor are capable of weekly repayments shows that the poor are capable of savings, even if it is only in small amounts. One of the reasons

why the poor might not save in financial form might be the lack of appropriate products”.

he over-zealous use of micro lending by private enterprises raises a basic question of conflict of interest and exploitation. What's worrying policy makers and regulators is the issue of poor borrowers being exploited by private banks to reap profits and to keep their shareholders happy. The concern is not unfounded. MFIs borrow from banks at around 12% and lend at anything between 25% and 30%. Such high interest rates ensures MFIs and their investors obtain huge returns on their equity. The ROA of some of micro lending institutions is astonishing: it is 6.8 for SKS Microfinance; it's 1.7 for HDFC Bank and 1.1 for SBI. No wonder, credit expansion has become an end in itself, with productivity and profitability benefits keeping the lenders happy. Sadly, for poor borrowers, it is the same uncaring lender, but in a different guise.

The issue does not remain limited to what is considered to be abnormal or supernormal profits, but goes beyond raising concerns like imprudent lending, excess loaning, coercive methods of recovery and regulatory backlash.

Matters came to a head when a State Government enacted an ordinance that effectively stopped collection of micro-debt and prohibited any new micro-loans in the State unless certain conditions were met. Recently, the governments of Andhra Pradesh and Kerala asked MFIs to comply with local rules that regulate the money lending activity. Andhra Pradesh has also passed an ordinance to regulate MFIs, one that stops short of capping interest rates. Regulatory issues are getting more complex by the day.

Further, excessive expansion of rural credit has not been accompanied by growth of deposits in rural areas. Banks have funded most of the micro credit by unwinding their surplus investments in government securities. This has led to a basic mismatch between deposits and credit. This kind of gap is bound to constrain the growth of micro lending in near future due to liquidity problems. Excessive imbalance can pose threat to the stability of the entire financial system.

Apart from these systemic issues, the ground reality is that more than 100 million people still have to rely on moneylenders or relatives for loans. Microfinance has not been able to extend the outreach of the financial services to rural poor as is exhibited by the data in the following section. Further, it has been lopsided in favor of credit dispersal alone and has completely failed to create a more financially secure and accessible environment.

III. EXTENT OF EXCLUSION IN INDIA

Despite various policy initiatives, in India financial services continue to be accessible to only a small section of the population. The excluded section has a demand for these services but remain unserved on account of lack of outreach and systemic issues. As a result they have to depend on informal sector to fulfill their financial needs and such services are usually rendered by local money lenders at exorbitant rates and on exploitative conditions, causing a vicious cycle, at times leading to further deprivation and social exclusion.

Data derived from the NSSO Study shows that 64.95 million cultivator households and 46.6 million non-cultivator households respectively do not have access to formal financial services. NSSO data reveal that 45.9 million farmer households in the country (51.4%), out of a total of 89.3 million households do not access credit, either from institutional or non-institutional sources. Further, despite the vast network of bank branches, only 27% of total farm households are indebted to formal sources (of which one-third also borrow from informal sources). Apart from the fact that exclusion in general is large, it also varies widely across regions, social groups and asset holdings. The poorer the group, the greater is the exclusion.

Extent of Exclusion in India becomes obvious from the low coverage data of financial services in India (*Estimates based on various studies and Market Surveys*):

1. Coverage of

Check in accounts-40%
Life Insurance-10.0%
Non-Life Insurance-0.6%
Credit Card-2%
ATM + Debit Card-13%

2. Geographical Coverage

Only 5.2% of India's 650,000 villages have bank branches even though 39.7% of the overall branch network of Indian banks, or 31,727, are in rural India. Overall, the population covered by each branch has come down from 63,000 in 1969 to 16,000 in 2007 and the total number of check-in accounts held at commercial banks, regional rural banks, primary agricultural credit societies, urban cooperative banks and post offices during this period has risen from 454.6 million to 610.3 million. Still, very few people in the low-income bracket have access to formal banking channels

TABLE 1: FINANCIAL INCLUSION STATISTICS IN INDIA

<p>(a) General:</p> <p>51.4% of farmer households are financially excluded from both formal / informal sources.</p> <ul style="list-style-type: none"> - Of the total farmer households, only 27% access formal sources of credit; one third of this group also borrow from non-formal sources. - Overall, 73% of farmer households have no access to formal sources of credit. <p>-----</p> <p>(b) Region-wise:</p> <ul style="list-style-type: none"> - Exclusion is most acute in Central, Eastern and Northeastern regions-having a concentration of 64% of all financially excluded farmer households in the country. - Overall indebtedness to formal sources of finance alone is only 19.66% in these three regions. <p>-----</p> <p>(c) Occupational Groups:</p> <ul style="list-style-type: none"> - Marginal farmer households constitute 66% of total farm households. Only 45% of these households are indebted to either formal or non formal sources of finance. - About 20% of indebted marginal farmer households have access to formal sources of credit. - Among non-cultivator households nearly 80% do not access credit from any source. <p>-----</p> <p>(d) Social Groups:</p> <ul style="list-style-type: none"> - Only 36% of ST farmer households are indebted (SCs and Other Backward Classes–OBC-51%) mostly to informal sources. <p>-----</p> <p>Analysis of the data provided by RBI through its Basic Statistical Returns reveal that critical exclusion (in terms of credit) is manifest in 256 districts, spread across 17 States and 1 UT, with a credit gap of 95% and above. This is in respect of commercial banks and RRBs.</p> <p>As per CMIE (March 2006), there are 11.56 crore land holdings. 5.91 crore KCCs have been issued as at the end of March 2006, which translated into a credit coverage of more than 51% of land holdings by formal sources. Further data with NABARD on the doubling of agricultural credit indicates that agricultural loan disbursements during 2006-07 covered 3.97 crore accounts. Thus, there are different estimates of the extent of inclusion through formal sources, as the reference period of the data is not uniform. Consequently, this has had an impact on quantifying the extent of levels of exclusion.</p>
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Source: Committee on Financial Inclusion, IDBI Gilts Ltd

Only 34% of people with annual earnings less than Rs. 50,000 in urban India had a bank account in 2007. The comparative figure in rural India is even lower, 26.8%.

Anil Ambani, the billionaire chairman of Reliance-Anil Dhirubhai Ambani Group, said in the recent annual general meeting of one of his group firms that nearly 400 million Indians have bank accounts. That's less than 40% of the country's population. Reserve Bank of India deputy governor, K.C. Chakrabarty, in a recent presentation on financial inclusion in Mumbai, said about 40% Indians have check-in accounts. Going by his presentation, 51 out of every 100 Indians had bank accounts in 1993. This has marginally gone up to 54 in 2007. Yet another presentation by another central banker, a few years back, had said 59% of adult population in India has bank accounts and that there is a large gap between the coverage of banking services in urban and rural pockets. In rural India, the coverage among the adult population is 39% against 60% in urban India. This, of course, doesn't necessarily mean that 60 out of every 100 Indian adults in cities have bank accounts as many people operate multiple accounts. Table 1 exhibits latest financial inclusion statistics in India.

(<http://indiamicrofinance.com/financialinclusion-in-india-some-key-statistics.html>)

IV. POLICY INITIATIVES TO INCREASE FINANCIAL INCLUSION IN INDIA

The concept of financial inclusion in India can be traced back to the year 1904 when co-operative movement started. It gained momentum in 1969 when 14 major commercial banks of the country were nationalized and lead bank scheme was introduced shortly thereafter. Branches were opened in large numbers across the country and even in the areas that were hitherto being neglected. Bank nationalization in India marked a paradigm shift in the focus of banking as it was intended to shift the focus from class banking to mass banking.

The rationale for creating Regional Rural Banks was also to take the banking services to poor people. The branches of commercial banks and the RRBs have increased from 8321 in the year 1969 to 68,282 branches as at the end of March 2005. The average population per branch office has decreased from 64,000 to 16,000 during the same period. The new branch authorization policy of Reserve Bank encourages banks to open branches in these under banked states and the under banked areas in other states. The new policy also places a lot of emphasis on the efforts made by the Bank to achieve, inter alia, financial inclusion and other policy objectives.

As on March 31, 2011, according to RBI, the number of 'no-frills' account stood at 7439 lakhs, number of bank branches in rural areas was

33,463 constituting 37.4% of the total bank branches and the number of Kisan Credit Cards was 224.9 lakhs. Figure 2 shows that rural and Semi-urban offices constitute a majority of the Commercial Bank offices in India. Rural bank offices as a % of total have increased from 22% in 1969 to 41% in 2007. So reach has definitely increased.

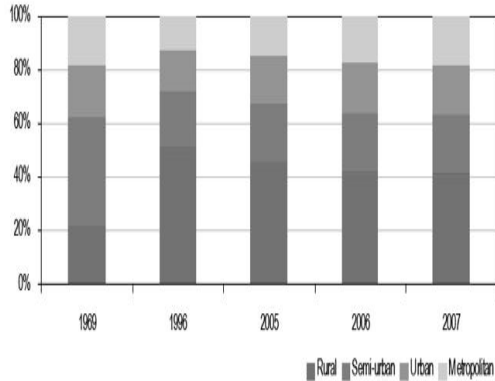


Fig. 2: Distribution of Bank Offices in India

Source: Rakesh Mohan, RBI, IDBI Gilts Ltd.

The Annual Policy Statement of the RBI (2005-06), laid down policies to encourage banks to increase the reach of banking services to the unbanked population of the country. The policy has also defined mechanism for monitoring of the services from the point of view of cost, implicit or explicit denial or any other barriers to providing basic banking services to masses. Banks have been urged to review their existing practices and policies to align them with the objective of financial inclusion.

In 2009, the Reserve Bank of India set time bound targets and assigned banks to reach the unbanked, who were estimated at 480 million and mostly living in India's 630,000 villages. It said that all 72,800 villages with a population of above 2,000 should have banking access by March 2012 and all 348,000 villages with a population of above 1,000 by March 2013. Or, about 70% of villages covered. Work done so far seems to be impressive. "What could not be done in the last 50 years has been done in the last six," says Usha Thorat, who retired as an RBI deputy governor in 2011.

RBI data shows that between March 2010 and June 2011, the number of villages covered has doubled to 107,000 and the number of bank accounts has grown 60% to 80 million. Banks did not open branches, and relied on their roving representatives—banking correspondents (BC) - to cover three out of four new locations.

Table 2 exhibits the initiatives taken by RBI since independence for increasing financial inclusion in the country

TABLE 2: RBI INITIATIVES FOR INCREASING FINANCIAL INCLUSION IN INDIA

<p><i>1969-1991</i></p> <p>Expansion of branch network—average population covered per branch reduced from 64000 to 13711—liberalization/ opening of economy—financial sector reforms—deregulation—increased competition—strengthening of banks through recapitalization—prudential measures—Indian banking now robust & able to achieve global financial inclusion</p> <p><i>Annual Policy Statement 2004-05</i></p> <p>“..banks should be obliged to provide banking services to all segments of population on equitable basis.”</p> <p><i>November 2005</i></p> <p>Banks advised to provide basic banking “no frills” accounts with low or minimum balance/ charges—expand banking outreach to larger sections of population—printed material used by retail customers made available in local language</p> <p>KYC principles simplified to open accounts for customers in rural & urban areas—Balances not to exceed Rs. 50000 & credits Rs. 1 lakh in a year—Introduction by a customer (KYC)</p> <p>General purpose Credit Card (GCC) facility up to Rs. 25000 at rural & urban branches—Revolving credit—Withdrawal up to limit sanctioned—Based on household cash flows—No security or collateral—Interest rate deregulated</p> <p>One-Time Settlement (OTS) for overdue loans up to Rs. 25000—Borrowers eligible (after OTS) for fresh credit</p> <p><i>January 2006</i></p> <p>Bank allowed to use services of NGOs, SHGs, micro finance institutions, civil society organizations as business facilitators/ correspondents (BC) for extending banking services—BCs allowed to do “cash in-cash out” transactions at BC locations & branchless banking Credit counseling & financial education – Pilots set up</p> <p><i>April 2006</i></p> <p>1 district in each state identified by SLBC for 100% financial inclusion—13 district identified in NER for FI – RBIEvaluation of progress through an external agency</p> <p><i>June 2007</i></p> <p>Multilingual website in 13 Indian languages launched by RBI providing information on banking services</p>

Recent Initiatives: Setting up of financial literacy centers– Credit counseling centers–National financial literacy drive–Linkage with informal sources with safeguards–IT solutions –Low cost remittance products etc.

Committee for FI: Dr. C. Rangarajan’s (Chairman: PM’s Economic Advisory Council) 10-Member Committee

Business Correspondents (BCs): Post offices, cooperative societies, NGOs (trusts/societies) being used as BCs for branchless banking–Agency risk reduced thru local organizations & IT solutions for tracking transactions – Door step banking at lower cost–Viability & scalability dependent on lower interest rate & service charges

IT Solutions: Essential for doorstep banking – Pilot projects by SBI using smart cards for opening a/c with biometric identification–Link to mobile/ hand held connectivity devices ensures transactions getting recorded in banks’ books on real time basis – State governments making pension & other payments under NREGS through smart cards – Other financial services (low cost remittances, insurance) provided through cards–IT solutions enable large transactions like processing, credit scoring, credit record & follow up etc.

Role of Government: Proactive role by issuing identity cards for a/c opening, thru awareness campaigns by district/ block level officials, meeting cost of cards, financial literacy drives–India Post being used as BCs

FM’s Budget Speech 2007-08: 2 Funds: (i) Financial Inclusion Fund–developmental/promotional work (ii) Financial Inclusion Technology Fund–technology adoption/innovation–Each Fund of \$ 125 million

Bank of India, M.K. Samantaray, General Manager, RBI, Guwahati

All this data notwithstanding, the real issue remains unresolved. The number of accounts and number of branches may have increased, but most of these accounts are inactive. Banking services are not being used by the rural poor despite government claims of having boosted the outreach. It is clear that financial deepening needs to be sustained through other measures, over and above the expansion of geographical outreach, if India’s ambitious plans to alleviate poverty and have a more inclusive growth are to be achieved.

V. TOWARDS REAL FINANCIAL INCLUSION: LESSONS FROM INTERNATIONAL EXPERIENCE

A study of data on international levels of financial inclusion reveals that India is lagging far behind in the list, despite the policy push and government initiatives. The author recommends that the regulators and policy makers should try to draw lessons from the international experience in order to ensure that financial reach goes beyond a meaningless number crunching.

Table 3: Index of Financial Inclusion

Index of Financial Inclusion		
Country	IFI	IFI Rank
Spain	0.79	1
Germany	0.60	4
United Kingdom	0.43	17
United States	0.37	21
China	0.30	32
Brazil	0.21	44
India	0.17	50
Indonesia	0.14	60
Bangladesh	0.12	69
Russia	0.07	83

Source: <http://www.businessstandard.com/india/news/sunil-jain-financial-inclusionindex/331995/>

Each country has its own unique experiences in financial inclusion but each offers learning in itself. Some of the important and relevant parameters may be summarized as (Figure 3):

Innovative Product Offerings

Introduction of a savings based demand driven sustainable microfinance program called PATMIR where savings have precedence over credit (Mexico)

Piloting of concept of Savings Gateway (UK)

Basic Banking Account (BBA)

Free encashment of Government cheques (even for non-customers)–(Canada)

Post Office Card Account (POCA)–(United Kingdom-UK; USA)

Credit Unions (UK)

“MZANSI”–a low cost card-based savings account with easy availability at accessible outlets like merchant points-of-sale, post offices, etc. (South Africa)

Enhancing Customer Awareness and Education

Banks contributing to a Money Advice Trust (UK) Face to face money advice provided by identified counseling points, viz., citizen advice bureaus, community development groups, etc. (UK)

Funding and Resource Generation

Set up of a Financial Inclusion Fund with corpus of £ 120 million to offer 3-way access to banking services, affordable credit and money advice (UK) Set up of Financial Inclusion Task Force for monitoring (UK)

Increasing Outreach

Existing rural outlets converted to commercial units (BRI model–Indonesia).

MoU between the Federal Government and financial institutions on financial inclusion to ensure the access to affordable banking services by all citizens (Canada) Building Inclusive Financial Sectors in Africa-BIFSA

Enabling Legislations

Legislation on Access to Basic Banking Services Regulations ensures that all citizens could obtain personal bank accounts without any difficulty (Canada)

Community Reinvestment Act (CRA) prohibits discrimination by banks against low and moderate-income households (USA)

The Bank Act makes the access to bank accounts a legal right (France)

Regulatory framework along with strengthening institutional capacity, supervision through autonomous supervisory committees (Mexico).

Institutional restructuring coupled with deregulation of the banking sector and removal of restrictions on credit and interest rates.

Supervision delegated while building mainline supervisory capacity in Bank of Indonesia (BI)-(Indonesia)

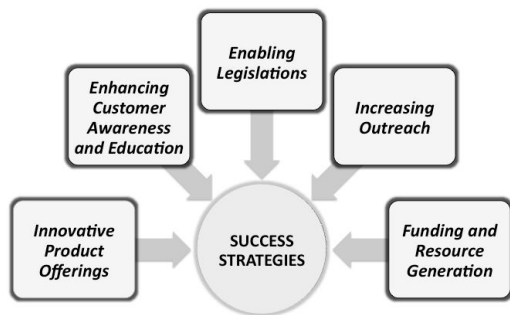


Fig. 3: International Success Strategies for Financial Inclusion

Source: Developed by the Author

Based on the study of the success strategies adopted worldwide for deepening of financial inclusion, the author suggests following imperatives that need to be addressed to take financial inclusion to the next level in India:

- Promoting awareness, disseminating information and imparting training or increasing FINANCIAL LITERACY, covering areas like advice on money management, debt counseling, insurance and savings.

- Dividing rural landscape into exclusion areas to develop intensive policies suited to each local community and unique needs.
- Strengthening delivery mechanism through developing, sensitizing, training and engaging specialized talent to bring professionalism and efficiency.
- Enacting empowering and enabling regulations for client protection, literacy and equitable distribution with scope for exceptions to meet the special needs of excluded communities.
- Expanding outreach through non-financial distribution channels, local communities and private participation
- Minimizing promotional and intermediation cost
- Leveraging technology, adapted to the needs of largely illiterate masses, to provide access to financial services in remote areas
- Customized, flexible product offerings, tailor made to suit the typical needs of poor people.

VI. CONCLUSION

To sum up, financial inclusion is a necessary condition for India to become a global economic power. There exists enough empirical evidence to prove that economic growth follows financial inclusion. Financial access and deeper markets, representing large number of customers, will definitely attract global financial giants and the lure of profits and numbers will make them gravitate more towards India. Inflow of international funds will result in increasing employment and business opportunities, thereby starting a positive cycle of growth and more growth. New business opportunities and foreign investment will definitely increase the gross domestic product and improve the standard of living. Thus, nation's prosperity can be increased through reducing the number of people excluded from the benefits of financial services.

Increasing financial inclusion requires a multidimensional strategy that has empowerment, participation, private enterprise, policy thrust and local commitment as its corner stones.

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