Towards Financial Inclusion in India

Ashish Gupta
MBA - I, Finance

"Fortune lies at the bottom of the pyramid"

-C K Prahalad

Financial Inclusion in India has become a cliché' but still a lot of us continue to be nonchalant towards the phenomenal initiative. We read about it, talk about it, but are apathetic towards its implementation for a sole reason that we do not know the ideal path to be followed. In order to figure it out it is imperative to know the reasons for a large part of our population to remain financially excluded. Let's first delve into the financial structure of the country.

There are 203 million households in India, out of which 147 million are in rural areas. This huge chunk of the population has access to only three types of financial products, simple credit facilities, basic saving account or a fixed deposit, and insurance. Only 48% of India's population has access to these elementary financial services compared to 59% in Sri Lanka, 60% in Malaysia and 63% in Korea. The poorest group spends the highest proportion of income on food (60% -90%). Any drop in earnings or additional expenditure (health or funeral cost) has immediate consequences on family welfare.

Rural finance consists of following main sectors:

Informal sector (not regulated by banking sector) - this includes moneylenders, rotating or accumulating savings and credit associations.

Semi-formal institutions - not regulated by banks but licensed and supervised by another govt. agency such as self help groups (SHG), NGOs involved in provision of financial services.

Formal Institution - subject to banking regulations and supervision, such as banks and microfinance.

Amongst all the sectors the informal segment rules the rural market with a share of $82 billion. Moneylenders are said to control a third of all rural loans. Annual credit demand is about 1,50,000 crores but demand of only 4000 crores is met. Despite having such a huge market why are the private and foreign banks still reluctant to tap it?

Issues and concerns with distribution in rural markets

- Due to fierce competition from new and existing financial service providers, the companies concentrate more on urban areas in order to maintain growth in their top line as well as bottom line. Thus opening up new branches in semi-urban/rural areas, setting up advanced technologies for non branching facilities and providing educational facilities require high capacity outlay.
- Scale of investment in rural areas is very low. People have low incomes and are risk averse. Income levels in urban households are 85% higher.
- Customers are scattered over wide areas creating accessibility problems for the financial service providers. Huge cost is incurred on setting the required infrastructure. Rural investors do not

prefer travelling long distances to avail the financial service due to lack of accessibility, awareness and willingness.

- Rural Infrastructure is in a poor state with no roads, electricity, telecommunication and Internet networks creating operational hurdles.
- Irregularities in payments
- There have always been problems in obtaining relevant documents for verification such as PAN, ration card, birth certificate, etc.
- Promotion of financial products is difficult as the sales and marketing personnel are required to understand the local customs, culture and language.

Despite so many challenges there are quite a few reasons for providing financial services in rural areas.

Reasons to tap rural market

- Rising income levels of the semi-urban and rural population in India
- Rapid semi-urbanization observed in rural areas
- Saturation of urban markets
- Rising credit demand
- As the rich is becoming richer and poor becoming poorer due to unavailability of services the wealth inequality will continue to increase at a faster pace in years to come and lead to a hollow growth of the world's second fastest growing economy.

It is not that the concept of financial inclusion is a recent phenomenon in India. For realization of this dream govt. and private sector have taken quite a few steps in past. In 2006, RBI approved setting new branches on condition that 50% of the branches have to be opened in the unbanked areas. Currently RBI has proposed a draft where it will also encourage foreign banks to open their new branches in tier III to tier VI cities. In the same year, RRBs were allowed to market mutual fund units based on approval from Board of Directors. RRBs can enter into distribution agreements with private or foreign mutual fund houses for marketing their schemes based on terms and conditions specified by RBI. Other efforts by govt. include issue of kissan credit cards (KCC), creation of no frills basic bank account, simplified general purpose credit card with a revolving credit limit of Rs 25000 for rural households, creation of Financial Inclusion Fund and Financial Inclusion Technology Development Fund in 2007-08 budget and promoting financial literacy in rural areas by proposing a scheme of Financial literacy and counseling centers (FLCC).Regulators (SEBI, IRDA, RBI) have also played a significant role in the process such as:

- Maintain a minimum proportion of life insurance policies sold in rural areas, necessitating setting up of distribution network in rural areas
- Launched financial info website in Hindi, English and 12 regional languages that aims at teaching basics of banking and finance.

Private sector has played some role in its capacity as well but such examples are very few. ICICI has entered into an agreement with ITC's e-choupals to make use of its distribution network for delivery of financial products. It also started franchise model in rural markets. Kendra, a one man office in the village formed an interface between the villagers and bank's products and facilities - crop loans, housing loans, automobile loans, farm equipment, seed financing and insurance policies. On similar lines Reliance Money has also opened up its franchise outlets providing employment to five local youths followed up by deploying 10,000 internet enabled trading kiosks across rural areas of the country to enable its customers to transact in equity, commodity derivatives, mutual funds and IPO.

Steps towards financial inclusion

- Creating financial literacy continues to be the major challenge in a country which suffers from low literacy and thus imparting basic financial knowledge will be a daunting task.
- Customize /repackage the financial products. Different promotion strategy in urban and rural households as rural households prefer more of saving oriented schemes fulfilling long term goals such as cost of a daughter's marriage, security during dry period, cost of funeral in case of some unforeseen death or health problems, whereas in urban areas tax consideration plays a key role.
- Access new distribution channels such as network of NGOs, post office, PSBs, etc.
- Establishing more credit bureaus for greater risk assessment of households.
- Regulators should impose targets to achieve certain level of penetration in rural areas. e.g. - a mutual fund should be required to spend certain amount of profits on generating financial literacy or investor education campaigns.
- Leverage on technology

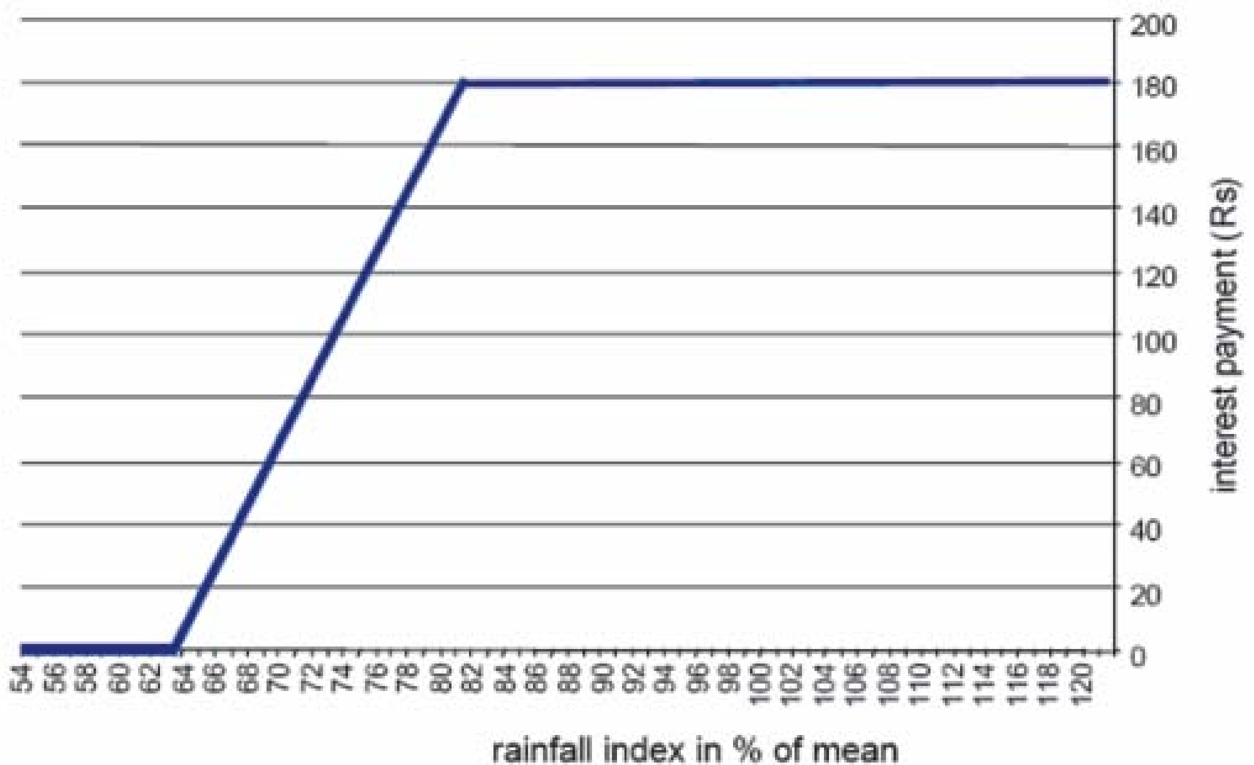
Apart from above mentioned measures one of the most crucial steps which is going to play a key role in marching towards financial inclusion would be innovation. What we are not able to understand is that there is one basic issue, i.e. high default rate and irregularity in income, which if not given due consideration will lead to collapse of the whole system and efforts put in for expansion of financial services in rural areas will be a waste. This is where our innovative financial products will come handy. A classic example of this is monsoon indexed lending and insurance for smallholders.

Monsoon indexed lending and insurance for smallholders

Farmers relying on rain fed agriculture in particular do not have access to formal crop finance, because banks perceive the risks as too high for the type of (capped and regulated) interest rate they can charge. Weather risk and moral hazard can tend to be higher for the rain fed farmer.In the case of monsoon-related crop failure, a culture of low payment morale sets in as the crop failure and resulting default on debts are seen as force majeure. In addition, political pressures for debt forgiveness tend to rise in drought years. This proposed scheme seeks to transfer systemic risk out of the farmer-bank relationship into insurance markets. It can lower the moral hazard problem by removing any excuse for non-repayment in case of monsoon-related crop failure.

The borrower pays a higher interest rate in normal years that comprises the weather index insurance premium, but in case of a severe rainfall deficit and in one case excessive rainfall in critical periods the

borrower pays little or no interest on the loan. For example in Ujjain, Madhya Pradesh, a crop loans for soya farmer receiving a crop loans of Rs 2000 with embedded weather insurance would pay have an interest rate of 20.5 percent instead of 17.5 percent. The overall rate goes up due to the weather insurance premium, but bank envisions being able to lower the base rate at a later date. The insurance kicks in when cumulative weighted rainfall during the critical growing periods falls below 80 percent of the mean. The farmer receives relief on his/her interest payments of Rs 10 per mm of rainfall index deficit. Where the yearly rainfall is 75 percent of the mean, the farmer would pay Rs 130 in interest instead of Rs 180. The relief on interest payments relief is an important break for farmers, whose budgets are strained after a failed harvest. The desired effect is to keep the farmer bankable even through drought years.



This is just one of the several innovative products that can be possibly designed. Another example is an extension of this product where in a part of regular payments is directed towards a saving accounts which act as a collateral for farmers which further helps them to raise more funds as it improves the creditworthiness of the farmer.

Thus, merely having regulations will not be sufficient to serve the gigantic task but it is the combination of the two, "Regulation with Innovation", that is going to be the success mantra.

References:-

1. *Innovative Financial Services for Rural India, Agriculture and Rural Development working paper 9*
2. *Distribution of financial products in India - Deutsche Bank*
3. *AVID Insight , financial sector in India*
4. *Providing financial services in rural areas, World Bank paper*
5. *Telecenter blog*