Duvvuri Subbarao: Financial inclusion – challenges and opportunities

Remarks by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the Bankers' Club, Kolkata, 9 December 2009.

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1. Being in Kolkata, this city of joy, is always a heart warming experience. Being here in the pre-Christmas season is a particular delight, and for me personally, a nostalgic memory. My special thanks to the Bankers' Club for inviting me to speak here this evening. I recall our meeting at this Club last year when we were in the thick of the deepest financial crisis of our time, and all of us were anxious and uncertain about the immediate future. I believe the worst is behind us. Attention around the world and here in India too is shifting from managing the crisis to managing the recovery. As that happens, we are also returning to addressing our enduring challenges – of lifting nearly half a billion people out of poverty. There are many things we need to do to accomplish that gigantic task. One of them is financial inclusion. I would like to focus my comments this evening on the challenges and opportunities of financial inclusion.

Financial inclusion – a thousand flowers blooming

2. If you will, let me begin with a couple anecdotes. In rural Maharashtra, where people, like everywhere else in the country, face the daily challenges of water, sanitation, electricity and transportation, a number of women have improved their lives, and the lives of their families, by becoming entrepreneurs, all because they could take a bank loan.

- Take Aruna Gaikwad. Aruna, a farm labourer, began selling excess produce at the local market. An astute observer of the laws of supply and demand when it came to pricing fruit and vegetables, she soon saw an uptick in business. To expand, she needed to borrow money so that she could build her own vegetable stand. The loan helped her establish a thriving vegetable vending business, allowing her to shift away from the back-breaking work tending other people's fields. Her former hand-to-mouth existence had given way to a new reality, one which includes savings and checking accounts at the bank, and the credit needed to keep her kids in school – a good fortune she herself never had.
- And then there is Lakshmi Shellar. Widowed at 17, Lakshmi helped form a local self-help group. She spoke up and spoke out at meetings, and inspired other women in the group to take their future into their own hands. Meanwhile, she brought banking services to them. And she provided evening literacy classes. The 177 women of Lakshmi's self-help group have all borrowed and repaid their loans.

3. Aruna and Lakshmi are just two of the millions of women across the country who have demonstrated what is possible if only rural women can have access to basic financial services. This is what financial inclusion is all about – giving people an opportunity to build better lives for themselves and their children. That impulse, if given a chance, can contribute to sustained improvements in the quality of life at the community level and foster growth and poverty reduction at the national level.

4. But there remain tremendous barriers to unleashing this "fortune at the bottom of the pyramid." Chief among them: financial exclusion. This is a confluence of multiple barriers: lack of access, lack of physical and social infrastructure, lack of understanding and knowledge, lack of technology; lack of support, lack of confidence, among others. Overcoming these barriers is, in a nutshell, the challenge of financial inclusion.

Why is financial inclusion important?

5. Why is financial inclusion important? It is important simply because it is a necessary condition for sustaining equitable growth. There are few, if any, instances of an economy transiting from an agrarian system to a post-industrial modern society without broad-based financial inclusion. As people having comfortable access to financial services, we all know from personal experience that economic opportunity is strongly intertwined with financial access. Such access is especially powerful for the poor as it provides them opportunities to build savings, make investments and avail credit. Importantly, access to financial services also helps the poor insure themselves against income shocks and equips them to meet emergencies such as illness, death in the family or loss of employment. Needless to add, financial inclusion protects the poor from the clutches of the usurious money lenders.

6. There is another benefit of financial inclusion which we have yet to fully appreciate let alone exploit. Financial inclusion will make it possible for governments to make payment such as social security transfers, National Rural Employment Guarantee Programme (NREGA) wages into the bank accounts of beneficiaries through the “Electric Benefit Transfer” (EBT) method. This will minimize transaction costs including leakages. In parts of the country where such EBT has already taken off, the results are impressive and the experience of both payers and recipients extremely satisfying.

7. There are enormous benefits at the aggregate level too. The first and more obvious benefit is that financial inclusion provides an avenue for bringing the savings of the poor into the formal financial intermediation system and channel them into investment. Second, the large number of low cost deposits will offer banks an opportunity to reduce their dependence on bulk deposits and help them to better manage both liquidity risks and asset-liability mismatches.

Financial exclusion – the big picture

8. Effort at financial inclusion is not new; both the Government and the Reserve Bank have been pursuing this goal over the last several decades through building the rural cooperative structure in the 1950s, the social contract with banks in the 1960s and the expansion of bank branch networks in the 1970s and 1980s. These initiatives have paid off in terms of a network of branches across the country.

9. Yet the extent of financial exclusion is staggering. Out of the 600,000 habitations in the country, only about 30,000 have a commercial bank branch. Just about 40 per cent of the population across the country have bank accounts, and this ratio is much lower in the north-east of the country. The proportion of people having any kind of life insurance cover is as low as 10 per cent and proportion having non-life insurance is an abysmally low 0.6 per cent. People having debit cards comprise only 13 per cent and those having credit cards only a marginal 2 per cent.

10. The National Sample Survey data reveals that, in 2003, out of the 89.3 million farmer households in the country, 51 percent did not seek credit from either institutional or non-institutional sources of any kind.

11. These statistics, staggering as they are, do not convey the true extent of financial exclusion. Even where bank accounts are claimed to have been opened, verification has shown that these account are dormant. Few conduct any banking transactions and even fewer receive any credit. Millions of people across the country are thereby denied the opportunity to harness their earning capacity and entrepreneurial talent, and are condemned to marginalization and poverty.

12. But there is a brighter side to the story. Remember that illustration they give in business strategy courses. A business executive of a shoe company was sent to a large developing country to assess the market potential there. What he saw was millions of people

going without shoes. He came back and reported to the management that there was no business potential there because no one wears shoes. A few months later, a strategist of a rival company went and saw the same picture. He came back and reported to his management that there is tremendous business potential in that country because of the number of shoes they can sell. Ultimately, it is a question of mindset.

13. Banks must see the picture like the second business strategist, look at the opportunity at the bottom of the pyramid and move into financial inclusion in a big way.

RBI's efforts

14. Let me briefly outline the efforts pursued by the Reserve Bank to further financial inclusion. Our approach to financial inclusion aims at "connecting people" with the banking system and not just opening accounts. This includes meeting the small credit needs of the people, giving them access to the payments system and providing remittance facilities. This has led to some notable developments:

(i) ***No frills accounts:*** In November 2005, RBI asked banks to offer a basic banking "no-frills" account with low or zero minimum balances and minimum charges to expand the outreach of such accounts to the low income groups.

(ii) ***Easier credit facility:*** Banks were asked to introduce a General Purpose Credit Card (GCC) facility up to Rs. 25,000. However, total number of GCCs issued by banks as at end-March, 2009 was only 0.15 million.

(iii) ***Simpler KYC norms:*** In order to ensure that people belonging to the low income groups, both in urban and rural areas, do not encounter difficulties in opening bank accounts, the "Know Your Customer" (KYC) procedure for opening accounts was simplified for those accounts with balances not exceeding Rs 50,000 and credits thereto not exceeding Rs 100,000 in a year.

(iv) ***Use of information technology:*** Banks have been urged to scale up IT initiatives for financial inclusion speedily while ensuring that solutions are highly secure, amenable to audit, and follow widely-accepted open standards to ensure eventual inter-operability among the different systems. Two of the important initiatives are:

- ***Smart cards*** for opening bank accounts with biometric identification. These help the customers get banking services near their doorstep.
- Link to ***mobile*** hand held electronic devices for banking transactions. In October 2008, the RBI advised banks on issues relating to technology, security standards, and customer protection.

(v) ***EBT through banks:*** The Reserve Bank is in consultation with state governments to encourage them to adopt Electronic Benefit Transfer (EBT) by banks.

(vi) ***100% financial inclusion drive:*** The Reserve Bank launched a financial inclusion drive targeting one district in each state for 100% financial inclusion. In the light of the experience gained, coverage has been extended to other areas/districts. We carried out an external evaluation of the quality of 100% financial inclusion reported by banks. On that basis, in January 2009, we advised banks to: (i) ensure provision of banking services nearer to the location of the no-frills account holders through a variety of channels; (ii) provide GCC/small overdrafts along with no-frills accounts to encourage the account holders to actively operate the accounts; (iii) conduct awareness drives of the facilities offered to the no-frills account holders; (iv) review the extent of coverage in districts declared as 100 per cent financially included; and (v) efficiently leverage on the available technology enabled financial inclusion solutions.

Business correspondent model

15. Possibly the most important initiative of the Reserve Bank has been the Business Correspondent (BC) model. The BC model ensures a closer relationship between poor people and the organized financial system. Recognizing this, in 2006, we permitted banks to use the services of non-governmental organizations, micro-finance institutions, retired bank employees, ex-servicemen, retired government employees, Section 25 companies, and other civil society organisations as Business Correspondents in providing financial and banking services.

16. Even as the BC model has taken off, it needs to be fine tuned and monitored appropriately to improve its efficacy, including by better training BCs. Recently, we have further enlarged the scope of the BC model by permitting banks to appoint individual kirana/medical/fair price shop owners, individual Public Call Office (PCO) operators, agents of Small Savings schemes and insurance companies, individuals who own petrol pumps, retired teachers and self-help groups linked to banks as BCs. With a view to ensuring the viability of the BC model, banks have also been permitted to collect reasonable service charges from the customer in a transparent manner. Going forward, the Reserve Bank will endeavour to give complete flexibility to banks to appoint BCs with only a negative list of entities that would not be eligible.

Bank branch and ATM expansion liberalized

17. Last year, the Reserve Bank totally freed location of ATMs from prior authorization. In the October 2009 Policy Review, the RBI took a further big step by freeing branch opening in towns and villages with population below 50,000. Domestic scheduled commercial banks (other than RRBs) are now free to open branches in towns and villages with less than 50,000 population and are enjoined to ensure that at least one-third of such branch expansion happens in the underbanked districts of underbanked states. This will be one of the criteria in the Reserve Bank's consideration of proposals by banks to open branches in major city (tier 1 and tier 2) centres.

Expansion of banks in the north-east

18. To improve banking penetration in the north-east, the Reserve Bank asked the State Governments and banks to identify centres where there is a need for setting up either full fledged branches or those offering forex facilities, handling government business or for meeting currency requirements. We have also offered to fund the capital and running costs for five years provided the State Government concerned is willing to make available the premises and put in place appropriate security arrangements. Meghalaya has been the first off the block, and eight centres have been allotted to three public sector banks, following a bidding process. The Reserve Bank is working with other states in the north-east to institute similar arrangements.

Project financial literacy

19. Let me say a few words on the Reserve Bank's drive for financial literacy. Financial literacy is a stepping-stone toward financial inclusion. Moreover, as financial markets are becoming increasingly complex with serious problems of information asymmetry, the need for financial literacy has become even more acute. The Reserve Bank has initiated a "Project Financial Literacy" with the objective of disseminating information regarding the central bank and general banking concepts to various target groups. Our website is also available in 13 languages.

20. Our "Financial Education" web site link offers basics of banking, finance and central banking for children of all ages. In a comic book format, we simplify the complexities of

banking, finance and central banking, with the goal of making the learning fun and interesting.

Financial literacy and credit counselling

21. We have advised the convenor-bank of each State Level Bankers' Committee to set up a financial literacy-cum-counselling centre in any one district on a pilot basis, and based on that experience, to extend the facility to other districts in due course. So far, 154 credit counselling centres have been set up in various states of the country. These centres are expected to provide free financial education to people in rural and urban areas on the various financial products and services, while maintaining an arm's-length relationship with the parent bank.

Financial curriculum in schools and colleges

22. The Reserve Bank is furthering the financial literacy drive by collaborating with state governments across the country to include financial literacy curriculum in the school syllabus. We have launched a pilot in Karnataka. We gave material on banking, personal finance as well as on the Reserve Bank to the State Government. The Karnataka Government has adapted, translated and included much of this material in the curriculum for high school classes and this is slated to go on stream next academic year starting June 2010. Based on this experience, we want to mainstream this initiative across the country.

Financial inclusion – challenges and opportunities

23. Let me now turn to challenges to financial inclusion and the potential opportunities. The question we should ask ourselves is this: despite the rural policy-push, why are so many bankable people unbanked? There are barriers to access financial services emanating from both demand side and supply side factors.

24. From the demand side, the big barriers are the lack of awareness about financial services and products, limited literacy, especially financial literacy of the populace, and social exclusion. Many of the generic financial products are unsuitable for the poor and there is not much of an effort to design products suitable to their needs. The unfriendly and unempathetic attitude of the banks to the customers also plays an important role in undermining the demand for financial services. On top of that, exorbitant and oftentimes non-transparent fees, combined with burdensome terms and conditions attached to the financial products, also dampens the demand.

25. From the supply side, the main barrier is the transaction costs that the bankers perceive. Because of current low volumes, banks find that extending financial services is not cost effective. Furthermore, lack of communication, lack of infrastructure, language barriers and low literacy levels all raise the cost of providing services and inhibit bankers from taking initiative from the supply side.

26. A couple of weeks ago, the Reserve Bank, in collaboration with the Boston Consulting Group, organized a workshop on financial inclusion in our College of Agricultural Banking in Pune. The express purpose of the workshop was to listen to frontline managers operating in the field about the opportunities and challenges to financial inclusion. Accordingly, we invited to the workshop, bank branch managers, including from rural areas, and representatives of microfinance institutions and some NGOs. The chairmen of some large public sector and private banks were also present.

27. I must say that listening to the participants at the workshop was an enormously rich learning experience. The big take away from that workshop, for the Reserve Bank as an institution and for me personally, was that even as there are problems to extending financial

inclusion, these are not insurmountable. If the Reserve Bank and the commercial banks put their minds, and more importantly their hearts, together these problems can be resolved.

28. According to what we heard at the workshop, the three big challenges are: (i) cost; (ii) lack of robust technology; and (iii) lack of awareness. Some of these challenges are clearly being exaggerated and others can be easily redressed.

29. Cost, of course, is the main consideration. It is nobody's case that each of the over 500,000 villages in the country can each be covered through a brick and mortar branch. That is clearly not a "bankable" proposition. We need to go through the low cost Business Correspondent model and leverage technology to deliver financial services.

30. The Reserve Bank has encouraged banks to use IT-enabled financial inclusion by leveraging on the smart cards/mobile technology. Business Correspondents of banks are making extensive use of hand held devices/mobile phones to reach banking services to remote villages, and especially for Electronic Benefits Transfer of NREGA wages and social security payments. This has been very successful in Andhra Pradesh, and a state-wide project has recently been kicked-off in Orissa. In addition, pilot projects are underway in most states of the country.

31. As a village-to-village robust electronic remittance system is presently not available in the country, it can be enabled by building suitable infrastructure to connect the systems of various banks which are presently involved in Electronic Benefit Transfer (EBT) through the medium of Business Correspondents. A robust switch similar to the National Financial Switch (NFS) located for the purpose in the National payments Corporation of India/Institute for Development Research in Banking Technology may fulfil a long felt requirement of a nationwide remittance system for the country. This will make the remittance system more efficient, and therefore, more attractive.

32. I also want to emphasize that there is tremendous opportunity on the way forward for reducing costs by increasing volumes. Let me elaborate a bit. First, there is the demographic profile – the labour force in the 15–64 age group is going to increase. As job opportunities grow and these people start earning, their incomes provide a large and growing source of deposits for banks. Banks that are ahead of the curve in establishing a presence in the vast hinterland of the country will have a first mover advantage in exploiting this potentially huge opportunity. Second, there is the opportunity of capturing remittances. Although there are no firm figures, I have been told that thousands of crores of rupees of remittances take place across the country today, predominantly from migrant labour, and over ninety per cent of this happens through non-formal channels. If banks can capture even half of this into their fold, they will not only reduce costs for the labour making remittances but they will also have the advantage of an enormous, permanent float.

33. Third, EBT, the electronic benefit transfer, is another big opportunity. I believe banks are inhibited about pushing this forward because of the fear of the unknown: they are not certain that the business can be cost-effective. Banks are clearly underestimating the potential. If indeed, all or even most government payments to rural people are captured through the EBT mode, this again can give banks a large float and make it an attractive business proposition. So far there has been a sharing of the costs between banks and state governments with regard to EBT. As EBT mode expands and becomes universal, banks will find that this is a viable business model even without any service charges.

34. It is also relevant here to acknowledge the potential of the Unique Identification Number (UID) that Nandan Nilekani and his team are working on. The UID will be a powerful instrumentality for helping poor people establish their identity to meet the banks' KYC norms. I believe, this is going to reduce cash and non-cash transaction costs both to the banks and to the potential customers. The UID is another powerful illustration of harnessing technology to the benefit of the poor.

35. The Reserve Bank has made a commitment to bank-led model of financial inclusion and will support banks in their financial inclusion initiatives by way of information dissemination, sharing of best practices and also through regulatory incentives. However, I want to add that our commitment to a bank led model is not irrevocable. There are other models of financial inclusion that are being experimented elsewhere in the world. Should banks fail to come forward and exploit this opportunity of financial inclusion, the Reserve Bank will not hesitate to explore other models of furthering financial inclusion.

36. A word also to microfinance institutions (MFIs). Many banks have partnered with microfinance institutions that provide financial services to relatively high risk segments of the population. Microfinance has provided access to finance to an entire sector of people left behind by the formal financial sector – and micro finance has demonstrated how these low-income categories are indeed a "bankable" proposition. But cost remains an issue. Interest rate charges – at 24–30 percent – seem too high. Compared to the informal sector, perhaps the rates are lower, but there are questions about whether these rates are affordable. Ideally, the rate of interest charged should not be out of alignment with the cost of funds, transaction costs, risk costs and a certain margin, and in any case, there is a need for transparency in its determination and fairness in its application.

Way forward

37. On the way forward, the Reserve Bank will push three targets. First, the lead bank in each district has been asked to draw a roadmap by March 2010 for ensuring that all villages with a population of over 2,000 will have access to financial services through a banking outlet, not necessarily a bank branch, by March 2011. As an aside, let me also tell you that many consumer goods companies have unveiled specific strategies that target villages with a population of less than 5,000 as micro-markets. It seems to me that as bankers, you can also follow your clients to their markets. Second, all commercial banks – public sector banks, private banks and foreign banks – are going to be asked to come up with their specific Board approved plans for financial inclusion by March 2010. These plans are intended to be rolled out over the next three years. We, in the Reserve Bank, have refrained from deliberately imposing a uniform model on the banks because we wanted each bank to build its own strategy in line with its business model and comparative advantage. This will hopefully ensure better ownership. The Reserve Bank is consulting the Indian Banks Association in this regard. Third, we learnt from the frontline managers in the Pune workshop that top managements of banks do not sufficiently emphasize, much less reward, efforts at financial inclusion. To remedy this, we are going to ask all banks to include criteria on financial inclusion in the performance evaluation of their field staff.

38. The Reserve Bank values two-way communication. By listening, we learn to appreciate people's needs and aspirations. This pushes us to be more sensitive, innovative and responsive. One of our initiatives in our Platinum Jubilee year is reaching out to remote villages – with a focus on financial education – spreading awareness about the economy, emphasizing the role the Reserve Bank plays in everyday life and making the general public aware of the financial services that the banks offer and the benefits of using the banking services. The outreach programme is a simultaneous effort to educate low income groups to demand financial services and to encourage banks to supply financial services needed by the poor. I must say that experience to date from the outreach programme has been immensely rewarding and fulfilling. I want to thank the commercial banks which are actively cooperating with us in this outreach programme.

39. Last week, I visited Jalanga village in Orissa as part of the outreach programme. I was very impressed by the self-help groups – groups of usually women who get together, pool their savings and give loans to members – and how these groups have empowered the women by giving them financial independence and thereby confidence. More than just hope,

these women have the vision to imagine how they can take advantage of the slightest opportunities and to work hard to make it happen.

Conclusion

40. Let me conclude by reiterating, even at the cost of being clichéd, that banking on the poor can actually be a rich banking proposition. Financial inclusion is a win-win opportunity for the poor, for the banks and for the nation. Because of growing incomes, and improving awareness levels, aspirations of the poor are on the rise. We will not be forgiven if we do not rise up to meet these aspirations if only because of poverty of imagination. It is for the banks to convert what they see as a dead-weight obligation into an exciting opportunity and move on aggressively on financial inclusion.