K C Chakrabarty: Financial deepening by putting financial inclusion campaign into mission mode

Address by Dr K C Chakrabarty, Deputy Governor of the Reserve Bank of India, at the 23rd Skoch Summit, Mumbai, 17 June 2010.

* * *

1. Dr C Rangarajan, Hon'ble Chairman, Economic Advisory Council to the Prime Minister, Mr Hari Sankaran, Managing Director and CEO, IL& FS, Shri S. S. Tarapore, Distinguished Fellow, Skoch Development Foundation, Shri J Sriram, CEO Mobile Commerce Venture, Bharti Airtel Ltd, and of course the main organiser of this function Mr Sameer Kochhar, distinguished guests, ladies and gentlemen. I have come here to say a few words about financial inclusion which is closely related to the topic of this Summit, i.e. Financial Deepening. One of the preconditions for deepening of any process is the existence of a large number of participants. Hence, financial inclusion is a necessary condition for financial deepening.

2. Let us consider how financial deepening can address concerns of growth with equity and ensure pro-poor growth. Financial sector development and deepening drives economic growth by mobilizing savings and investing in the growth of the productive sectors. The institutional infrastructure of the financial system contributes to reducing information, contracting and transaction costs, which in turn accelerates economic growth and promotes pro-poor growth. We firmly believe that increasing financial inclusion reduces the economic vulnerability of households, promotes economic growth, alleviates poverty and improves the quality of peoples' lives. Thus, expansion of banking leads to increasing availability of finance to spur economic growth and helps alleviate poverty.

Barriers to this process

3. Barriers for poor people to access appropriate financial services include socio-economic factors e.g., lack of education-illiteracy, gender and age, low and irregular income, and geography, regulatory factors e.g. mandatory requirements of identity documentation and product design factors.

4. A major barrier cited to expand appropriate services to poor by financial service providers is the cost of providing those services including administering small loans. While transaction costs do not vary in direct proportion to a transaction's size and larger number of transactions bring down the costs, serving the poor with small value services is not viable using conventional retail banking or insurance approaches. We have to promote technological and institutional innovation as a means to expand financial system access and usage, including addressing infrastructure weaknesses.

5. Innovation in delivery and design of financial services targeting the poor and the excluded, presents challenging policy and regulatory issues. Even the G-20 has set up the Financial Inclusion Experts Group to address these issues of ensuring Financial Inclusion and global safety nets. Global awareness of the challenges and barriers and hands-on experience with policy, regulation and supervision is limited. Industry innovation has thus far frequently outpaced the capacity of policymakers to respond. When we talk of reaching to the people, we must understand what types of problems are faced by customers and what is the solution. Any policy and regulatory responses will therefore need to focus on articulating flexible approaches that can take account of multiple and competing objectives and that can accommodate further innovation. A key source of innovation is the capacity of technology to reduce costs and overcome other barriers to the provision of sustainable financial services to the excluded.

6. Till a few years ago, there was a dearth of appropriate technology. But, now that technology has arrived, we have taken several initiatives to bring about financial inclusion. What we require is a business model and a delivery model. With this in view, RBI advised banks to formulate a board approved financial inclusion plan for the next three years. All banks have drawn up their financial inclusion plans and we are engaged in active discussions with banks on their plans. Through this approach, we are putting the financial inclusion campaign into mission mode. Based on our assessment and learning, we have advised them to review and revise their plans. Our broad approach on achieving planned, sustained and structured financial inclusion is as under:

Technology: seamless integration of front-end with back-end

7. First, the transformational role of technology needs to emphasised. Financial deepening is taking banking to people. We are speaking of this for the last four decades post nationalization; we have failed if we see that the current coverage is of barely 32,000 rural commercial bank branches. Scalable financial inclusion cannot happen without stable and reliable Information and Communications Technology (ICT). Not only the bank branches but also the branches of Regional Rural Bank's must also be on Core Banking Solution (CBS), without which it would not be possible to scale up the financial inclusion efforts. The transactions through the hand held front end-devices should be seamlessly integrated with banks' main server. These devices must be capable of transacting the four minimum products as mentioned in a subsequent paragraph. There should be a provision in the smart card for integration with the UID number under the Aadhaar Project.

Banking services: need to increase the bouquets of products

8. Second, it is not enough to open a No Frills Accounts (NFA) and maintain that banking services are available. De minimus, four banking products need to be provided for it to qualify as availability of banking services. These are:

a. A Savings cum overdraft account

b. A Pure Savings Product ideally a recurring or variable recurring deposit

c. A Remittance Product for EBT and other remittances

d. Entrepreneurial Credit such as GCC, KCC

The number of NFA opened present a very rosy picture, however, evaluation studies show that accounts once opened lie dormant as the poor do not have enough money to put in the deposit accounts. Hence, the need to transact is not there. If the banks want customer acquisition and that poor customers transact with them, they must permit overdrafts in the accounts. To begin with, very small amounts such as Rs 200, Rs 500 etc. could be sanctioned. The needs of the poor for consumption smoothing and for lifecycle events such as medical emergency, weddings, funerals, etc. are pressing and need immediate gratification. They need to be made aware that to meet their emergency credit needs, an overdraft facility exists and they can avail should they require. This would bring them to the banks to transact and enable the banks to sell other products apart from making the entire exercise viable. For those, who only wish to save, a pure savings product like a recurring or a variable recurring deposit product could be offered. A remittance product to facilitate EBT or other remittances should also be offered. For entrepreneurial credit, products such as GCC, KCC, etc. could be offered. This is the minimum set of products that needs to be offered. Beyond this, banks are free to provide any other products such as insurance, mutual funds, etc. as per their assessment and capability.

Coverage: need for transparency

9. Third, the issue of coverage. So far, even when a customer from a remote village comes and opens an account with a bank branch in a city, that city branch includes that remote village as covered by banking services. We are clarifying that for a village to be considered covered by banking services, either a bank branch has to be present or a Business Correspondent (BC) is visiting/present in that village. There must be a bifurcation between villages with more than 2000 population and those with less than 2000 population. The plan needs to cover in an integrated manner both categories of villages. The names of the BC/branch covering a particular village need to be indicated on the banks website.

Financial inclusion plan: integrated with banks' business plans

10. Fourth, financial inclusion plans must be integrated with the normal business plans of the banks. We believe that banking to the poor is a viable business opportunity but costs and benefit exercise needs to be attempted by the banks to make financial inclusion congruent with their business models. Banks must view financial inclusion as a huge business opportunity and perfect their delivery models.

Operational issues: need for intermediate structure

11. Fifth, the banks need to examine the operational issues related to the BC model such as cash handling. They need to evaluate whether an intermediate brick and mortar structure is required between the base bank branch and BCs for more effective supervision of the BCs. This structure, which should be manned by banks' own skeletal staff can have a safe where BCs can deposit cash, a CBS terminal and passbook printing facility. Over a period of time, this can morph into a full fledged satellite branch of the Bank

Urban financial inclusion: not to be lost sight of

12. Sixth, financial inclusion is sometimes erroneously treated as synonymous with rural poverty. Concerns of urban poverty also need to be factored in and the needs of various groups as rickshaw pullers, construction workers, migrant workers, etc. must be factored in and products and services crafted as per their needs by the banking system to address urban financial inclusion.

Monitoring: need for a structured approach

13. Seventh, we would be closely monitoring the progress made by the banks as per their financial inclusion plans. A structured reporting format has been made available for meaningful compilation and analysis of data. The banks need to do similar structured data compilation exercise at the state/district level which will facilitate monitoring at the district/state/bank level. A structured approach will ensure that this time the outcome of our financial inclusion efforts will be different and will not meet the same fate as previous ones.

Other issues

14. Let me reiterate that financial inclusion is not mere State Benefit Transfers. Loans must be extended and savings and borrowings habits need to be inculcated among the poor. Poor do not require cheap credit but prompt credit. It is an anomaly that while they are pressed to pay exorbitant rates of interest to the money lender, the mainstream financial institutions are still shy of lending to them. In the ultimate analysis, financial inclusion is a driver of economic growth and poverty alleviation.

15. Inclusive financial sector development makes two complementary contributions to poverty alleviation: financial sector development is a driver of economic growth which indirectly reduces poverty and inequality; and appropriate, affordable, financial services for poor people. Critical to our efforts at securing sustained economic growth are the expansion of last mile access to finance. Thus financial inclusion is no longer a policy choice but is a policy compulsion. In a bank based model, customers have a direct contractual relationship with a bank or similar prudentially regulated and supervised financial institution – a basic bank account, a savings account, a savings cum overdraft account, a transaction account, a loan, or some combination – even though the customer may deal exclusively with the staff of one or more retail agents hired to conduct transactions on the bank's behalf. In the non-bank based model the contractual relationship is with a non-bank service provider such as a mobile network operator or an issuer of stored-value payment instruments. Customers exchange cash at a retail agent in return for an electronic record of value. This virtual account is stored on the service provider's server. Nevertheless, although there is no contractual relationship directly between a bank and a customer, a bank is always involved, for example as a potentially safe and liquid place for the nonbank provider to hold the float .Our model in India as of now is a bank led model and in this way we are able to address consumer protection issues which are of paramount concern given the nature of the vulnerable clientele we are dealing with. Here, financial capability building through financial literacy and education also assume great importance. We have mandated the setting up of Financial Literacy and Credit Counselling Centres which are expected to go a long way in ameliorating the lot of the customer although it should be understood that first we have to provide financial access.

16. Finally, let me stress that currently we are marketing the paradigm of financial inclusion through the bank-led model. It is thus for the banks to rise up to the challenge and meet it in full measure. What we mean by no access to finance for the excluded is that no access from the formal financial system; so a word of necessary caution for banks; the paradigm of financial inclusion is ultimately one of the continued relevance for the banking sector as other actors are waiting anxiously in the wings waiting for a go ahead.

17. India has good IT talent as also financial sector talent and hence this experiment to bring ICT based financial inclusion is not only relevant to India but to the entire globe as success of this experiment can be replicated elsewhere. Entire world is looking at these developments with keen interest. We need to meet these expectations.

18. We have a broad based government-Central Bank commitment to financial inclusion to help alleviate poverty. Our aim is to help create an enabling policy and regulatory environment for innovative financial inclusion. The present enabling environment will critically determine the speed at which the financial services access gap will close for the people currently excluded.

19. Thank you. I wish the 23rd Skoch Summit all the best and hope the deliberations here throw new light on various aspects of financial deepening.