Y V Reddy: Financial inclusion and central banking – reflections and issues

Keynote speech by Dr Y V Reddy, Governor of the Reserve Bank of India from 2003 to 2008, at the 14th SEACEN Executive Committee Meeting and High-Level Seminar, Port Moresby, 1–4 October 2015.

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Governor Loi Bakani, Chairman, SEACEN Board of Governors, Deputy Governors, Hans Genberg of SEACEN, Madhusudan Mohanty of BIS, distinguished central bankers and friends.

I am thankful to the BIS and SEACEN for giving me the opportunity of being with central bankers again and delivering a keynote speech on a subject close to my heart. It is a pleasure and privilege to be with you again. It is said that "once a central banker, always a central banker", and so I remain one, although I joined the fraternity towards the end of my career. I continue to have a close association with SEACEN, where I meet old friends and make new ones.

I am grateful to Governor Bakani and his team for hosting this event; and for the excellent arrangements. Governor, you and your team have been courteous, pleasant, cheerful and helpful, and we greatly enjoyed the hospitality over dinner yesterday evening. We also had discussions, as all central bankers do when they meet, about worrying about what we should be worrying about.

In this presentation, I will share my personal reflections with you on the origins of financial inclusion as a concept and a policy in India; and how it became a joint responsibility of the government and the Reserve Bank.

I will follow it with what I may term the globalisation of financial inclusion as a policy and what is new about it after the Global Financial Crisis. I will then summarise the issues of concern to central banks that have been flagged so far.

I will conclude with what, I believe, are right questions, in addition to issues that central banks should be asking when they deal with financial inclusion.

I took over as Governor of the Reserve Bank of India (RBI) in September 2003. I continued with the reform process and like my predecessors recognised expectations that the RBI will continue to be involved in credit availability for development and stability. Also, I was not a blue-blooded central banker, having been in local, state and union governments. So, I wanted to project the Reserve Bank as an institution concerned with the common people and not just financial markets and financial institutions.

Keeping in view the need for continuity with change as appropriate to evolving circumstances, we in the RBI pursued five broad policy directions. First, reforms in monetary management consistent with global developments; second, alignment of bank regulation with global standards; third, improving legal and institutional infrastructure to enable a modern financial system, in particular in the payments system; fourth, harmonising as far as possible, developmental objectives with those of stability in consultation with government, and; fifth, exploring ways in which the financial sector could better serve ordinary people. I emphasised the fifth aspect, that finance should serve ordinary people, as opposed to making the assumption that the development of the financial sector by itself will contribute to economic development and welfare. Some initiatives, particularly those relating to financial inclusion in India since 2003, reflect this orientation towards the common people. Financial inclusion, thus, was not designed as a programme in isolation, but as a part of the overall strategy in regard to the role of the central bank, as warranted by the Indian context of inadequate access to essential financial services.

I was acutely aware, having been a Deputy Governor for six years, that the needs of the common person were not served well enough by the financial sector, despite all the investment, innovation and strengthening of existing institutions in the financial system, particularly banks. So, while pursuing the reform agenda already set, and in parallel, I put the focus on serving the needs of ordinary people in their interactions with the banking system. In doing this, I realised that our efforts were addressed to meeting the needs of those who already had links to banks. What about the rest, who actually were far more in number than those with links to banks? So, the reform agenda provided for improvements in the way that the financial sector served ordinary people better and ensuring that it would reach out to all.

My assessment of the common person's requirements at that time was as follows:

What do ordinary people in India, at this juncture want most from us, the central bank? First and foremost, a safe place to keep their cash especially for poor women who have to keep their earnings out of the reach of their drunken husbands. Second, mechanisms for consumption-smoothing since 90% of the population is employed in the unorganised sector with seasonal or uncertain income flows. Third, remittances to families by migrant workers; migration of labour within the country in search of seasonal employment was large. Workers had to migrate to urban areas in order to continue supporting their families in rural areas. This required attention to remittance facilities, also out in the countryside. Fourth, increased stringency in regard to know-your-customer and anti-money laundering requirements after 9/11 were hindering access for people in the unorganised sector to banking facilities. This understanding led me to a design for what we, at some stage, described as financial inclusion.

Prior to the formal articulation of this concept, with the support of Indian Bank, especially Dr Chakraborty and Mr Samba Murthy, we attempted a survey of people's access to banking facilities and their utilisation in one region. Efforts were also made to experiment with "no frills accounts" and "zero balance accounts". We made assessments that revealed a distinction between access and utilisation, and the underlying factors. A major issue was the all-in cost of a financial service. For instance, when the costs of travel to a bank, foregone wages for that day, the need for documentation, and uncertainty about the timely availability of credit are included, the cost of formal credit to the borrower may exceed that of credit from an informal source.

In parallel, the Institute for Development & Research in Banking Technology (IDRBT) in Hyderabad, in collaboration with the Government of Andhra Pradesh, was experimenting on the scope for transfer of funds from the government to individual beneficiaries of government cash disbursement programmes via the use of technology. This required the opening of accounts for individual beneficiaries who were widely dispersed and large in number. This laid the foundation for what has been described as a new system of government-to-person payments.

A committee under the chairmanship of Mr H R Khan gave several recommendations, of which the Business Correspondent Model was an important one. We tried to expand the reach of each bank branch through a correspondent; and the bank was expected to ensure compliance of the correspondent with all the RBI's regulatory requirements. People had comfort that they were linked to a bank branch and the Reserve Bank could have some regulatory comfort. Microfinance institutions, which were for the most part not-for-profit institutions at that time, were also supported as instruments of financial inclusion. They, however, tended to concentrate on areas that were already banked or covered by self-help groups sponsored by banks, such as those in Andhra Pradesh. A measure that had great impact on financial inclusion was making all ATM transactions across all branches, irrespective of where accounts are held, free of charge. This initiative actually became a means of transferring money to migrants and students at no cost. It reduced the need to hold cash in advance of needs. Unlike a branch, it was a place where everyone, rich or poor, was in the same queue.

As we were undertaking all these different measures, I wanted to communicate this policy commitment to meeting the needs of ordinary people for essential financial services in the Monetary Policy Statement of 2005. Mrs Usha Thorat, the Deputy Governor, and I worked together on a draft. It required several painstaking interactions. A literature review indicated that most policy measures in this regard related to the development of financial markets, financial sector deepening, regulation of financial institutions and payment, clearing and settlement systems and, to some extent, the provision of microcredit. There were some examples of policy actions that addressed the issue of exclusion from facilities available through banking system. Examples were found mainly in the United States. In France we found that access to a bank account was a right. I initially considered the title of “Financial exclusion” and a description of measures to overcome it. As I was finalising the draft of the Annual Policy Statement for the year 2006–07, issued on 18 April 2006, it struck me that what had been attempted particularly in the past year was actually reaching out, and hence the title should be “Financial inclusion”. This articulation by the Reserve Bank is the origin of the concept of financial inclusion. It also paves the way for the central bank’s involvement, in India at least.

The concept of financial inclusion as articulated by the RBI caught the imagination of many people, particularly in state governments. It also attracted the attention of the central government, and a Committee on Financial Inclusion under the Chairmanship of Dr C Rangarajan was appointed. Financial inclusion was formally defined by the Committee, as “the process of ensuring access to financial services and timely and adequate credit where needed to vulnerable groups such as weaker sections and low income groups at affordable cost”. Mrs Usha Thorat was also a member. The Committee’s report (January 2008) presented what I may call the “government’s view” of financial inclusion, and continued to give a central place to provision of credit to vulnerable sections, especially for productive purposes, as an important ingredient of the financial inclusion concept. The main responsibility for the programme was assigned to the National Bank for Agriculture and Development, an apex development institution in India.

These are the origins of the concept of financial inclusion, which has now become an agenda item in public policy with responsibility shared between the government and the RBI. However, it first caught the attention of the global community immediately after the Global Financial Crisis in 2008.

Globalisation of financial inclusion

I believe that financial inclusion gave a positive twist to the policy responses to the Global Financial Crisis (GFC). The GFC warranted a massive coordinated policy intervention, by both governments and central bankers, to save the world economy from depression. The financial sector was viewed as a villain by many, and governments and central banks were often accused of bailing banks out at great expense to the exchequer. In the context of the GFC and Occupy Wall Street etc, policymakers must have felt a need to demonstrate that they were concerned as much with people as with finance. Further, they had to create a direct stake for larger segments of the population in the financial sector that they were intending to build for the future.

Many developing countries were concerned for quite some time with issues of connecting people with finance, but for the global community this became an issue only as a consequence of the GFC. Before the GFC, for advanced economies, the focus was on extending credit to those without assets.

The G20 statement and subsequent follow-up actions by various multilateral institutions have to be viewed in this context. Financial inclusion was put on the G20 agenda in November 2008 and, in 2010, it became one of the pillars of the global development agenda. So, we now have the G20's Financial Inclusion Action Plan and the Global Partnership for Financial Inclusion, apart from follow-up work by the IMF, World Bank and BIS, among others. As a result of the GFC, the policy of leaving it to the markets had to be replaced with a promise of a little more financial sector regulation. To secure a wider acceptance of globally coordinated actions, a commitment to bailouts had to be accompanied by a policy of reaching out to the underprivileged.

The net result has been that central banks, who pre-GFC were required to focus on monetary policy with a single objective or at least one primary objective, namely, price stability, are now encouraged to add financial stability to their concerns and also financial inclusion.

What is new?

As the Indian case has illustrated, central banks and governments all over the world have been taking measures, as part of their normal policies, to ensure the availability of and access to financial services for all segments of population. In particular, developing countries have been promoting microfinance, which has been recognised as a form of financial inclusion. So, what is new about financial inclusion? I will attempt a few generalisations.

First, as already mentioned, financial inclusion, along with financial stability, has become the joint responsibility of central banks and governments. However, developing and emerging market economies have become leaders in innovation in this regard, since their requirements are huge.

Second, the objectives of financial inclusion have been expanded to encompass ease of financial transactions and economic development, well beyond addressing issues relating to the provision of credit to the underprivileged. Financial inclusion is expected to deliver on several fronts. It is expected to provide a more stable retail deposit base and reduce reliance on borrowed funds. Combined with IT solutions, it is a powerful catalyst for payments system and remittances. It could enhance financial stability by improving the health of household sector. It is also expected to help in the monitoring of suspicious transactions by expanding the scope for the formal sector. Financial inclusion is also expected to lead to innovative solutions, as it extends the provision of financial services to a larger and more diverse population. There are claims that financial inclusion could also help reduce income inequality and narrow the gender gap. Policies for financial inclusion, which were hitherto restricted to credit and, to some extent, deposit-taking, cover several financial products, especially insurance products. There have been some voices, such as the IMF's, which take a balanced view of the benefits, costs and risks of various components of financial inclusion.

Third, new types of bank, with a special focus on local areas and specific tasks, are being considered, as in India. No doubt, many countries have community banks and other institutions, but financial inclusion has led to a search for new institutions with a different focus. Non-bank financial institutions are also involved in financial inclusion. Policies for financial inclusion recognise and, indeed, emphasise the role of for-profit enterprises to ensure scalability and sustainability. This is in contrast to microcredit, where in the past not-for-profit institutions and the integration of credit with income generation were preferred. Not-for-profit entities such as the Bill Gates Foundation have extended full support to the global initiatives in this regard.

Fourth, the coverage of financial inclusion has been expanded from households to include small enterprises, small businesses and some organisational forms. At the same time, limits are set in terms of transaction size to define what constitutes financial inclusion.

Fifth, some of the regulatory and procedural prescriptions that had inhibited financial inclusion, such as know-your-customer, are being revisited.

Sixth, above all, technological developments are throwing up vast opportunities for financial inclusion.

Finally, for very valid reasons, financial inclusion recognises a variety of policies packaged as appropriate for different countries. They may reflect differing degrees of emphasis on deposit-taking, extending credit, easing transactions and remittances, or popularising or innovating financial instruments. Data have been collated and are being analysed on many aspects of financial inclusion for purposes of cross-country comparisons, and difficulties in interpreting the data are recognised.

The Indian case

Financial inclusion as currently understood in India is, in some ways, different from what I had envisaged when it was adopted in India. The RBI's policy objective for financial inclusion at that time was related to activities within its jurisdiction, namely, the payments system, banking system, and to a limited extent, non-banks that were under its jurisdiction. RBI put a high priority on the spread of financial literacy and financial counselling. To the extent that financial inclusion has a broader import, government then took the initiative, as recommended by Dr Rangarajan's Committee, and the major instrument was the National Bank for Agriculture and Rural Development (NABARD). Currently, India's financial inclusion policy encompasses several objectives, several institutions and several financial products, and the central bank is the major instrument of national policy. The intellectual origins of the current policy may be traced to the Nachiket Mor Committee, while a massive policy thrust was given by the Prime Minister in 2014. The national government has galvanised the RBI, the regulator, the public sector banking system, and disbursements by governments. So the RBI now appears to be the lead agency in the implementation of financial inclusion policy.

The game changers in Indian policy in the recent past have taken advantage of the opportunities provided by technology for implementing financial inclusion. This needed significant changes in institutional and regulatory systems. Avenues other than public sector banks, on whom the main burden of Financial Inclusion policy fell, are being explored. The initiative still remains bank-led but with different types of bank. RBI has taken the lead in this regard.

A new policy framework has been designed by the RBI following the report of the Nachiket Mor Committee. The Committee recommended four design principles and advocated multiple models and partnerships. They also recommended differentiated banks. The Prime Minister's Jan Dhan Yojana, the National Mission for Financial Inclusion, gave a boost to the implementation of the recommendations.

In July 2015, the RBI constituted a Committee to formulate a Medium-Term Path on Financial Inclusion at the Prime Minister's suggestion to take the lead in encouraging financial institutions and to set a medium- to long-term target for sustainable inclusion. The Committee has representation from academia, bankers, the Bill Gates Foundation and other parties. The components of financial inclusion are specified, and include payments, deposit, credit, social security transfers, pensions and insurance.

Simultaneously, small finance banks in the private sector have been licensed, primarily to undertake basic banking activities such as deposit-taking and lending to unserved and underserved sectors including small businesses, small and marginal farmers, micro and small industries, and unorganised sector entities. These are, in some ways, similar to local area banks, an experiment that was abandoned, but with a significant difference, namely, that there is no restriction in their area of operations.

A more innovative initiative is licenses to payment banks, of which the Department of Posts with its deep penetration is one. The banks offer only deposits, which are described as an enhanced version of a prepaid wallet. Banks have to consider a model that will allow people to deposit and withdraw cash. The benefits expected include seamless payments, swift remittances, a higher rate on deposits, and the replacement of unregulated entities. Banks may potentially become sourcing agents for third-party products, such as insurance and mutual funds. This is uncharted territory. We had a category known as non-bank finance companies, and two such entities out of six accounted for over 70% of total deposit-taking activities in the non-bank finance category. They were permitted to take retail deposits across the country and expected to invest the money almost wholly in government securities. RBI viewed them with disfavour and encouraged them to quit and change their business model. But the payment banks are expected to be vastly different in some respects.

Thus, in India, financial inclusion has become a national policy with the Prime Minister and, hence, the government taking the lead and the RBI being the most important institution involved in the policy.

Issues

Recent developments in regard to the emphasis on financial inclusion and the responsibilities assigned to or assumed by central banks raise several issues and these have been well documented. I will flag them here to facilitate deliberations in the meeting.

First, how far are the central banks going to the other extreme, from a "one target-one instrument" to a "multi target–multi instrument" approach to central banking? How much would this result in a dilution of the focus of central banks? What should be the relative emphasis between the various objectives?

Second, under the new dispensation, there is a widening of central bank mandates. How much would this widening result in a dilution of the independence of central banks?

Third, in view of recent developments relating to the responsibility for and response to global financial crisis, the independence of central banks and, more importantly, the credibility of central banks is under stress. At the same time, the central banks, by and large, are already in uncharted waters in handling the exit from the Global Financial Crisis. How far would the acceptance of financial inclusion as a major responsibility at this juncture threaten the effectiveness of central banks' core function, namely, monetary policy.

Fourth, there is evidence that very high expectations have been created for a positive outcome for the programme of financial inclusion. It is being described as a win-win game. National targets that appear to be quite ambitious have been adopted. To what extent would the central banks face reputational risks in the event of the expectations not being met?

Fifth, there is increasing recognition that there are limits to what monetary policy can achieve, and there is acute awareness of complexities of regulation of financial sector. In such an environment, how far could a central bank deliver some of the laudable objectives of financial inclusion, such as poverty alleviation, reduction of inequality and environmental improvements?

Sixth, do central banks have the expertise to be closely involved in a wider programme of financial inclusion since the demand factors are difficult to assess, even assuming that the central bank can ensure the supply of financial services?

Seventh, what are the lessons that could be learnt from experience in regard to programmes for financial inclusion, including those from the US housing bubble, credit facilities to government employees in South Africa, and microfinance in India?

Eighth, a programme of financial inclusion, as generally understood in the current global initiatives, warrants inter-agency regulatory coordination. The policy encompasses regulatory institutions, financial institutions, financial instruments, financial markets and governmental programmes. Three major roles have been identified for the governments by the IMF in the programme, ie promoter, enabler, and developer. Is there a global understanding of what governments could do in this regard, corresponding to what central banks are expected to do?

Finally, relative to advanced economies, emerging and developing economies possess valuable experience and have a greater stake in the debates on financial inclusion. Perhaps, they could contribute more than before to global knowledge and wisdom on this subject.

Asking the right questions

There are issues for central bankers in pursuing the goal of financial inclusion, but central banks cannot afford to ignore their legitimate role in financial inclusion. In fact, the adoption of such policies has a humanising influence on central banks. However, each central bank has to carve out its role and responsibilities in this regard carefully, with a view to enhancing its effectiveness and mitigating downside risks. With this objective, let me suggest a list of questions that the participants in the seminar could address during the deliberations, in addition to the issues that I have listed.

First, what are the externalities that require or demand that global standards are set for the policies that affect financial institutions? What is the likelihood and risk of a country's financial inclusion policy influencing other countries? In other words, is there enough justification for considering or recommending global standards in regard to financial inclusion?

Second, financial inclusion is predominantly a problem for emerging market economies and other developing countries. The weight of their financial sector in global finance is very limited. It is unlikely that a programme for financial inclusion would warrant global attention, however significant it may be for its home country, except as a part of an issue affecting the wider global economy such as poverty, environment and public health. To what extent should the definition of financial inclusion be extended beyond households to include provision of credit to enterprises, thus diluting the focus of financial inclusion?

Third, is it possible that a programme for financial inclusion will be treated as a substitute for a commitment to provide the poor with public services such as education and health, or, in other words, is such a programme likely to undermine the global commitment to welfare programmes?

Fourth, a policy on financial inclusion essentially involves moving frontiers of formal finance into informal finance, particularly in regard to households. By its very nature, the informal sectors in different countries and in different communities are highly varied and deeply rooted in local conditions. So, should the focus be on learning from other countries' experiences, as considered useful by individual countries?

Fifth, is there merit in focusing on financial services and products, other than credit, inasmuch as credit involves issues of risks and leverage, much more than other banking products do? In other words, what should be the relative emphasis on different components of financial inclusion such as remittances, deposit-taking, consumption-smoothing, vis-à-vis financial products such as insurance? The relative emphasis may, of course, be country-specific.

Sixth, a study by the IMF indicates that too much emphasis on credit could adversely affect stability. Easier credit delivery as part of a policy of financial inclusion may lead to the excess indebtedness of poor households, as experience has shown. If the emphasis is on credit, which institution will bear the risks involved? Should the central bank assess the risks, if any, in the respective country's financial inclusion programme and, in particular, who would bear the risks? Would it be the banking system or the central bank or government?

Seventh, experience in India shows that institutions such as local area banks that address exclusively one area or one segment of the population or one type of activity may not be viable unless the regulatory environment is softer than that of their competitors. At the same time, soft regulation provides an opportunity for arbitrage. Smaller institutions with limited expertise may find it difficult to deliver financial inclusion. At the same time, there are very few mechanisms available to ensure that larger conglomerates will find it profitable to adopt this programme. In other words, what are the limitations on instruments available to the central bank to implement financial inclusion programmes?

Eighth, what would be the role of regional or local government in the financial inclusion? How does a central bank co-opt such local governments? My experience suggests that local governments, especially in large economies, are better able than national governments to reach poorer sections of the population.

Ninth, do we recognise that the major issue is not one of inclusion or exclusion, but huge inequalities in terms of inclusion? A low-income person has to pay disproportionately higher fees for any financial service than a high-income person does. This is common to both advanced and emerging economies. Can and should central banks address the issue of terms on which financial inclusion takes place? Should we propose equitable terms of financial inclusion for the global agenda?

Finally, the limits to the spread of financial inclusion may be set by the economic or social disadvantages of segments of the population. Financial inclusion programmes may do many things to facilitate financial transactions and financial sector coverage, as well as the penetration and the efficiency of financial sector, but the temptation to treat them as a panacea must be resisted. They can at best facilitate but cannot deliver employment, development, equity or environmental benefits. The most important lessons of the Global Financial Crisis must not be forgotten. Financialisation in excess doses can be injurious to health. Finance can facilitate, but cannot lead, and central banks should focus on money and finance, while never ignoring economic, social and political factors.

Let me conclude by saying that financial inclusion is an important policy that gives a human face to the tasks of central banking. But its role in policy depends on how broad or how narrow the scope of financial inclusion is in any given country. It would be useful to demarcate what government should do, what central banks could do, and how they should relate to each other in pursuit of a national policy for financial inclusion.

Thank you.

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