H R Khan: Financial inclusion and financial stability: are they two sides of the same coin?

Address by Shri H R Khan, Deputy Governor of the Reserve Bank of India, at BANCON 2011, organized by the Indian Bankers Association and Indian Overseas Bank, Chennai, 4 November 2011.

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It is always a pleasure to be a part of such a confluence of bankers and researchers on contemporary issues in banking and finance but to choose to speak on an area which needs to be either "wholesomely new" or "extensively revised" at such a forum becomes a challenge. I thank the organizers, the CMD of Indian Overseas Bank and the Chairman of IBA for offering me this opportunity to share my own thoughts on a topical issue that has engaged attention of policy makers in India and abroad in the recent times.

The Reserve Bank is intimately involved in efforts to ensure both financial inclusion and financial stability in India. Being a part of this institution, I have had a very large intellectual as also operational canvas to roam around. That in fact, encouraged me to avail of this opportunity to discuss these two important dimensions of the economic issues which have shaped the tone and tenor of financial sector policy space globally over the last decade or so. The more one deals with them in juxtaposition, the more their mutual exclusiveness gets demystified. Let me explain, how?

The importance of financial inclusion based on the principle of equity and on inclusive growth with stability has engaged the renewed attention of policy makers internationally in recent years. It is being increasingly recognized that despite tremendous growth in the banking sector and significant improvements in all areas relating to financial viability, profitability and competitiveness, *the glass remains half-full*. There remain concerns that banks have not been able to include vast segments of the population, especially the underprivileged sections of the society, into the fold of basic banking and financial services.

The recent global financial crisis has also brought the focus on financial stability to the centre stage. The debate has been quite wide-ranging encompassing, *inter alia*, the definition of financial stability and the implication of financial stability for growth and welfare. Many lessons have been learnt. One, that financial stability can be jeopardized even if there is price and macroeconomic stability. Two, that financial stability has to shift from being an implicit variable to an explicit variable of economic policy and three, that a threat to financial stability anywhere in the world is potentially a threat to financial stability everywhere. Fourth and most importantly, we have learnt that while financial instability can hurt even the most advanced economies, the damage it can cause in poor and developing economies can be particularly severe. People with low levels of income have no headroom to bear downside risks, and their livelihoods can be disrupted by financial instability. It is therefore even more important that countries such as ours pay particular attention to preserving financial stability even as we deepen and broaden our financial sector at home and integrate with the rest of the world[1].

The developments in the recent years have ensured that the pursuit of financial inclusion and the pursuit of financial stability are no longer policy options but policy compulsions. The key challenges emerging from this conclusion is how to achieve the goal of financial inclusion,

1 "Financial Stability: Issues and Challenges", D. Subbarao, September 2009.

i.e., providing basic financial facilities to a wider segment of society while ensuring that the stability of the financial system is not compromised. An important question which emerges is whether increased and wider access to the formal financial services works in tandem with policies aimed at enhancing financial stability or does it work at cross purposes and jeopardize financial stability, i.e., are financial inclusion and financial stability two sides of the same coin or are they two different disparate goals.

These are some of the issues I have picked up to enunciate. First, I will share my thoughts on how financial inclusion and financial stability must co-exist and that it is difficult, in the longer term, to envisage prevalence of one without the other. Next, I will discuss the various ways in which financial stability and financial inclusion complement each other, going on to discuss the ways that they may be in conflict and work at cross purposes. I will then touch upon how a suite of enabling regulatory framework, effective policies for consumer protection and greater financial awareness and literacy can work together to exploit the synergies between financial inclusion and financial stability. Finally, I will briefly outline the manner in which financial stability considerations have been woven into the Reserve Bank's initiatives towards greater financial inclusion.

Financial inclusion and financial stability: mandatory co-existence

The first point I would like to make as I explore the relationship between financial stability and financial inclusion is that the two must co-exist. Financial inclusion may be difficult without the stability of the financial system while it is difficult to envisage continuing financial stability when an increasing chunk of the socio-economic system remains financially excluded. Let me elucidate.

Financial inclusion has been defined, by the Committee on Financial Inclusion, as *the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost*[2]. It primarily represents access to a bank account backed by deposit insurance, access to affordable credit and the payments system.

There has been significant, *albeit*, slow progress towards greater financial inclusion around the world in recent years. According to estimates by an ADB Working Paper[3], in Africa, Kenya has pioneered an interesting process of financial inclusion through mobile phone payment solutions. Latin American countries such as Peru and Bolivia have attempted to put in place some very enabling regulatory environments for microfinance. In these two countries, rapid growth over the past seven years has included six million clients in the formal financial system. Brazilian policymakers achieved universal coverage of over 5,500 municipalities by enabling banks to use retail agents. This new low-cost delivery channel triggered expansion of formal financial services to 12 million clients in only six years. Latin America has also demonstrated the potential of conditional cash transfers into simplified bank accounts as a way to connect beneficiaries to formal finance while simultaneously lowering delivery costs to the government. Transfer challenges motivated the use of agents in Brazil. In Mexico, beneficiaries increased savings and investment with more than 90 per cent of households started to use banking services.

The benefits from financial inclusion are well understood and well documented. Financial inclusion, more particularly when promoted in the wider context of economic inclusion, can uplift financial conditions and improve the standards of lives of the poor and the disadvantaged. Access to affordable financial services would lead to increasing economic

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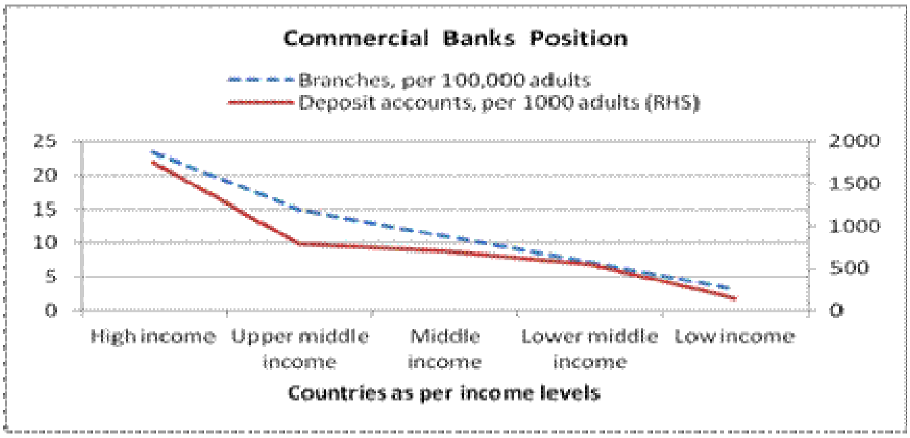
2 As defined by the Committee on Financial Inclusion (Chairman: C. Rangarajan, 2008).

3 ADBI Working Paper Series No. 259 – "Financial Inclusion and Financial Stability: Current Policy Issues" (Dec 2010).

activities and employment opportunities for rural households with a possible multiplier effect on the economy. It could enable a higher disposable income in the hands of rural households leading to greater savings and a wider deposit base for banks and other financial institutions. It will enable the Government to provide social development benefits and subsidies directly to the beneficiary bank accounts, thereby drastically reducing leakages and pilferages in social welfare schemes. Thus, financial inclusion could be an instrument to provide monetary fuel for economic growth and is critical for achieving inclusive growth. Further, expanding the reach of financial services to those individuals who do not currently have access would be an objective that is fully consistent with the people-centric definition of inclusive growth which attempts to bridge the various divides in an economy and society, between the rich and the poor, between the rural and urban populace, and between one region and another.

An analysis of World Bank Development Indicators implies a strong link between financial access (measured in terms of commercial bank branches per 100,000 adults and deposits per 1000 adults) and economic development. Empirical evidence indicates a distinct rise in income level of the countries with higher number of branches and deposits of commercial banks. Higher number of bank branches per 100,000 adults and more number of deposit accounts per 1000 adults are observed in high income countries than countries in the low and middle income categories. Though the cause-effect relationship could be the subject of detailed research, the fact that there is a progressive increase in income levels of the countries as financial access increases is empirically evident.



Source: World Development Indicators 2010, World Bank

Just as it is difficult to envisage continuing financial stability without financial inclusion, especially in the long term, it is difficult to envisage the success of policy efforts to expand the reach of financial services unless banks and other financial services providers are sound, the financial markets are functioning smoothly and financial market infrastructure is robust. A recent World Bank report shows[4] that nearly 60 percent of the economies experienced a contraction in real per capita income in 2009 as a result of the deepening of the global financial crisis. Worldwide volume of deposits and loans shrank, with a median decrease of 12 percent in the ratio of deposit value to Gross Domestic Product (GDP) and a median decrease of 15 percent in the ratio of value of loans to GDP.

I have discussed how financial inclusion and financial stability need to co-exist if policy measures pursuing either objective have to achieve any degree of success. Let me return now to the key question I flagged at the outset – whether financial inclusion and financial

4 "Financial Access: The State of Financial Inclusion through the Crisis", Consultative Group to Assist the Poor (CGAP)/The World Bank Group , 2010.

stability are two sides of the same coin and mutually reinforce each other or are they disparate goals that would contradict each other and work at cross purposes. There are, in fact, several ways in which financial inclusion can contribute to maintaining a sounder and more stable financial system.

Financial inclusion and financial stability: working in tandem

First, financial inclusion can improve the efficiency of the process of intermediation between savings and investments while facilitating change in the composition of the financial system with regard to the transactions that take place, the clients that use the various services, the new risks created, and possibly the institutions that operate in newly created or expanded markets. As the balance sheet of the financial sector grows more diversified and encompasses a broader spectrum of economic agents, its contribution to a more resilient economy is commensurately higher.

Second, for financial institutions, especially banks, financial inclusion helps provide a more stable retail base of deposits. As the recent global crisis also demonstrated, stable retail sources of funding as against reliance on borrowed funds can greatly enhance the soundness and resilience of financial institutions and can reduce volatility in earnings. Low income savers and borrowers tend to maintain steady financial behaviour through the business cycle both in terms of deposit keeping and borrowing. Thus, during periods of systemic crises, deposits from low income clients typically act as a continued source of funds even as other sources of credit dry up or become difficult to roll over. Small customers, thus, provide big opportunities to garner stable deposits. In the absence of such deposits, financial institutions may find it difficult to continue lending. This credit channel has the potential to aggravate the impact of the crisis on the local economy than would otherwise be the case.

Third, financial inclusion facilitates greater participation by different segments of the economy in the formal financial system. The presence of a large informal sector can impair the transmission of monetary policy as a significant segment of financially excluded households and small businesses make financial decisions independent of, and un-influenced by, the monetary policy actions of the central bank. As the share of the formal financial sector increases through greater financial inclusion, it yields an important positive externality by making monetary policy transmission more effective.

Fourth, to the extent that financial inclusion helps people move from the cash economy to bank accounts which can be monitored, it helps facilitate implementation of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) guidelines and makes it possible to deploy suspicious transactions' monitoring and reporting to a larger share of financial transactions in the economy. Recent Financial Action Task Force (FATF) Guidance on[5] "Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion" concluded that financial exclusion undermines the effectiveness of an AML/CFT regime and recommended that a country's level of financial inclusion and initiatives to expand financial inclusion should be considered, when the effectiveness of their AML/CFT regime is assessed.

Fifth, financial inclusion can contribute to enhanced financial stability through contributing to the improved health of the household sector, of small businesses and, to some extent, that of the corporate sector. The health of the household sector is improved through improved economic linkages, reducing reliance on the costly informal sector and through improved ability to make and receive payments. The benefits of this cannot be overstated given that for the household sector the implications of a lack of access to banking services can be severe.

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[5] FATF Guidance on "Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion", June 2011.

Lack of access affects the ability of a household to receive government transfers, or to make payments or to accumulate cash surpluses for planned expenses or emergencies. Individuals who have no option but to carry cash are exposed to security risks. Such access also reduces the cost of making payments. Social benefits include protection against loss due to theft, improved mechanisms for social transfers and other remittances (including tax and benefit remittances) and improved economic linkages for the rural and deprived communities[6].The lack of access to or availability of a vehicle for saving could also result in households, especially low income households, resorting to expensive short-term debt. There are many anecdotal instances of high interest rates leading to households being caught in a debt trap in our own country while the impact on financial stability of increased leverage of households was succinctly demonstrated by the recent crisis in the microfinance sector.

Financial inclusion can improve the access to finance and the quality and cost of the service that small businesses receive from banks. These factors are key to the profitability and prosperity of these businesses and that of the economy. Research has revealed increased formal savings can help reduce cost of credit and facilitate business expansion, for example, through increased availability of low cost deposits. This has the collateral benefit of improving resilience of small businesses, even large businesses.

Sixth, in most cases, efforts to include an increasingly larger section of the population within the fold of formal banking and financial services have resulted in the deployment of innovative solutions and outsourcing arrangements. Such financial innovations have the potential of reducing costs and thereby contributing to increasing the overall efficiency of the economy and the financial stability. They may also, through faster information dissemination and more efficient functioning of the financial markets, contribute to improving the efficiency of transmission of monetary policy. Of course, financial innovations and outsourcing arrangements come with their own set of risks which could pose challenges for the overall policy framework for the pursuit of financial stability. But I will discuss this a little later.

Finally, financial inclusion, through careful policy orientation, may help facilitate reduction in income inequalities and, by bridging the gap between the prosperous and the poor, can foster social and political stability.

Financial inclusion and financial stability: working at cross purposes

This is not to say that there are no risks to financial stability emanating from greater financial inclusion. One only has to recall the savings and loan crisis in the US in 1980s to appreciate that even financial institutions geared to cater to the retail investors and, thereby, to foster financial inclusion, could be a source of financial instability.

The recent crisis in US subprime markets is another case in point. Policy makers have often endorsed marketing to subprime borrowers as a means of financial inclusion[7]. With hindsight, it seems clear that such over-extension of credit has the potential to affect the quality of the credit portfolio of banks and financial institutions and could have sown the seeds of financial fragility, and ultimately of financial instability. The position may be further aggravated by regulatory or governmental forbearance which has the potential to vitiate the credit culture amongst the target group. As elucidated by Prof. Raghuram Rajan[8], "easy credit" as a response to bridge the gap between the haves and the have-nevers could prove to be a

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6 "Financial Access and Financial Stability" – Paper written by P. Hawkins, FEASibility Limited South Africa for BIS (2010).

7 Collard, S. and Kempson, E. (2005), Affordable Credit: The Way Forward, York: Joseph Rowntree Foundation.

8 Rajan G., Raghuram (2010), *Fault Lines : How Hidden Fractures Still Threaten The World Economy*.

costly way of redistribution and create a fault line along the financial sector where enormous stresses could build up and lead to an instability in the system akin to the subprime crisis of recent times.

Our own experience with local entities, such as, cooperative banks, deposit taking non-banking financial companies and Regional Rural Banks – which are largely geared to meet the needs of the poor and the un-banked – has highlighted the risks of poor governance, connected lending, geographic concentration leading to vulnerability to natural calamities and downturns. The recent experience of the microfinance industry is another example of an initiative to foster financial inclusion resulting in financial stress to the very institutions which are promoting inclusion. Hence, the risks for financial institutions catering to the less developed and low-income markets need to be well understood.

First, these markets typically involve a large number of low ticket clients/transactions with commensurate burden on operating costs. Second, these segments are typically associated with informational inefficiencies with most borrowers unable to produce any collateral or to provide an adequate track record of repayments. Third, financial institutions venturing into these segments for the first time often need to incur substantial costs as they adjust their business practices and processes to the fresh rules of the game. Fourth, financial services can be used to launder illegally obtained funds as well as fund terrorist activities. This could be accentuated if for expansion of finance access too much of regulatory forbearance by way of relaxed KYC norms is given even for large volume/high frequency transactions. While, as discussed above, greater financial inclusion can facilitate monitoring of a larger share of suspicious transactions, the emergence of payment services, in particular person to person remittance facilities, to cater to the needs of an increasing large base of retail clients may also provide opportunities for illegal activities. Conversely, there are challenges posed by AML-CFT requirements to the goal of achieving financial inclusion and, hence, the FATF Guidance states there is a need to "*take account of the nexus between financial integrity and financial inclusion and the cross-reinforcement between these two objectives*".

Fifth, outsourcing of activities by banks, including for financial inclusion, also poses reputational, financial and fidelity risks which may impact the health of the institution and of the financial system[9]. In particular, the reputation risks associated with outsourcing may impact the activities of the entire bank and not just the outsourced activities in case of any mishap or misdemeanour by the outsourced agents. There are also systemic risks associated with the entire banking industry relying on a single or a few vendors, as is frequently the case, especially in the early stages of innovations/outsourcing. These risks need to be carefully managed by banks, in particular, through a system of checks and balances which could, *inter alia*, involve well defined contractual arrangements, standards for due diligence, exposure monitoring, cash and other limits, rating of the agents/Business Correspondents (BCs), periodic audit/inspection, etc. and the use of information, communication and technology (ICT), for managing operational and financial risks. Further, the design of appropriate compensation structures, including performance based features, can ensure a reasonable fee to the agents while ensuring adequate incentives for preventing misuse of the system by the agents.

Sixth, risks would also arise out of the business model of specialised non-bank institutions {e.g. Micro Finance Institutions (MFIs)} which cater exclusively to the needs of the low income group. These institutions face concentration and funding risks which can contribute to overall systemic risks as has been amply demonstrated by the recent experiences in Andhra Pradesh. The greater involvement of commercial banks in the provision of services to the low

[9] The Report of the Internal Group to Examine Issues relating to Rural Credit and Microfinance (Chairman: Shri. H. R. Khan), Reserve Bank of India, July 2005 (Khan Committee).

income group and with institutions catering to the low income segment can go a long way towards mitigating the risks.

Finally, as I discussed earlier, the pursuit of financial inclusion has often been attempted through low cost delivery channels, innovative products and outsourcing agencies. These developments come with their own set of risks which could jeopardize financial stability. For example, during times of stress, financial innovation can further complicate the transmission of monetary policy. In any case, during periods of financial instability, it may be difficult to predict the consequences of financial innovations thereby adding an additional element of uncertainty to an already uncertain economic environment.

Facilitating financial inclusion with financial stability: financial regulations and literacy & consumer protection

Let me quickly sum up the discussions so far. It is clear that there are some potential costs of financial inclusion. There are also some important benefits which play out over cycles of booms and busts and through periods of financial crises. The end result is a deeper, more diversified and resilient financial system as well as healthier corporate and household sectors which can enhance financial stability. There are risks to the financial institutions from financial inclusion. There is, however, not enough evidence that these risks are hugely systemic in nature. On the contrary, savers and borrowers in the lower segment have been evidenced to maintain more consistent financial behaviour during financial crises as compared to customers in other segments. To this extent, they add to the resilience of financial institutions. In any case, the risks prevalent at the institutional level are manageable with known regulatory & prudential tools, greater financial awareness and literacy and with more effective customer protection practices.

As highlighted at the very outset, achieving greater financial inclusion and maintaining financial stability are now complementary policy compulsions. The challenge is to ensure both while exploiting the synergies between the two policy objectives. The answer arguably lies in a facilitative regulatory and supervisory structure which ensures that the formal financial system delivers affordable financial services to the excluded population with greater efficiency without compromising on the acceptable levels of safety and soundness. In this connection, an important role can be played by credit information bureaus that provide a database to capture all outstanding loans for individual borrowers and in prevention of multiple-lending and over borrowing[10]. Also important is a regulatory environment which facilitates the promotion of new lines of businesses with idiosyncratic risk profiles whose contribution to systemic risks is relatively low.

An effective consumer protection policy framework is also a critical component of any regulatory environment which aims at meeting the goal of financial inclusion while promoting the soundness and resilience of institutions and of the financial system. For the entire framework to be effective, greater financial literacy and awareness would remain very critical.

There are a range of cross country experiences which testify to the efforts underway for the achievement of a balance between financial inclusion and financial stability through a facilitating regulatory framework, especially relative to consumer protection and reputational risk mitigation. Let me briefly recount some such experiences which have supported an accessible and stable financial sector environment in their respective jurisdictions:

a. Brazil, new regulations have been attempted to achieve universal access by enabling partnerships between banks and third-party agents. Brazil was the early leader in agent banking through the large-scale introduction of "banking

[10] Report of the Sub Committee of the Central Board of Directors of the Reserve Bank of India to Study Issues and Concerns in the MFI Sector (Chairman: Shri Y H Malegam), January 2011 (Malegam Committee).

correspondents” to distribute welfare grants to unbanked Brazilians. The oversight is focused on the financial institution with the central bank getting access to all data on the agents while attempting to also give the financial institution enough freedom to articulate the relationship with the agents on their own terms.

b. Kenya and the Philippines, where central banks have had a key role in supporting mobile phone payment schemes and allowed regulatory space to mobile phone operators. In Kenya, the e-money transfer service M-PESA offered by mobile network operator Safaricom has achieved impressive progress thus far.

c. Philippines launched the first successful mobile payment service in a developing country in 2004. Once market innovation and learning satisfied the needs of regulators and mobile operators, regulation was created and implemented to provide legal certainty and create a level playing field to allow new players.

d. Bolivia and Uganda, which also demonstrated that micro-deposit-taking can flourish in the regulated financial system with timely and appropriate policies. Regulators have incorporated non-profit innovators into the formal system by creating legal paths toward a license. New laws, specially designed for previously unregulated NGOs, were passed, whereby they will keep their non-profit status and be allowed to collect deposits and offer extra financial services.

e. Indonesia, which has proved how public-owned financial institutions may become the driving force behind economic development in rural areas. The government owned development bank, Bank Rakyat Indonesia (BRI), which specializes in microfinance is the biggest provider of rural financial services within Indonesia. Even when the Indonesian banking system collapsed during the Asian financial crisis, BRI’s micro-banking division remained relatively profitable [11].

It is, however, important to note all these experiences need to be evaluated in the country specific context and their replication in other jurisdiction has to be carefully thought through. The lesson, however, is that prudential regulation has an important role to play in ensuring the initiatives taken to provide basic financial services do not themselves become a source of risk or fraud. Prudential regulations which ensure the soundness of financial institutions providing basic financial services to the excluded, on the one hand, and which put in place robust consumer protection guidelines, on the other, bolster public confidence in the various initiatives taken to ensure greater financial inclusion.

If regulations are to foster financial inclusion, they need to be commensurate with risks. A recent BIS paper[12] highlights the need for regulation of financial innovations for financial stability to be calibrated to the nature and risks of each different service/innovation. In calibrating the regulatory framework for basic financial services according to their contribution to systemic risks for the entire financial system it will be necessary to ensure that financial regulation itself does not become a cause for exclusion.

The Indian experience

Let me now briefly describe the Indian experience with financial stability and financial inclusion.

Financial stability is not a mandate of the Reserve Bank of India as per its statute. Financial stability considerations have, however, always been taken note of by the Reserve Bank in its

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11 ADBI Working Paper Series No. 259 and “Small Customers, Big Market:Commercial Banks in Microfinance” by Malcolm Harper and S S Arora (2005).

12 On harnessing the potential of financial inclusion by Peter Dittus and Michael Klein: BIS, May 2011.

policy making process. This is particularly so in the period since the balance of payments crisis in the early 1990s. Since 2004, financial stability has been formally added as a policy objective of the Reserve Bank of India along with price stability and inclusive growth. More recently, financial stability is being pursued explicitly by the Reserve Bank with the setting up of a Financial Stability Unit with the remit to conduct continuous macroprudential surveillance of the economy.

Financial inclusion has also been a major policy objective in the Indian context since long though the term financial inclusion has come to the forefront only of late. In fact, the Reserve Bank is perhaps the only central bank in the world which attempts to reach the remotest locations of the country in a bid to create awareness and promote inclusion. The objective of achieving greater financial inclusion in India has been pursued in a regulated space. The framework for financial inclusion has been bank led to a large extent and banks are closely regulated and supervised entities in the Indian context. Non-Banking Financial Companies (NBFCs) engaged in activities which facilitate financial inclusion are also largely regulated while a regulatory framework for the Micro Finance Institutions (MFIs) is also under contemplation[13]. Importantly, the broad compulsions of the health and resilience of financial institutions and that of financial stability have not been lost sight of even as financial inclusion has been pursued with vigour. It is pertinent to note at this point that the remit of the recently established Financial Stability and Development Council (FSDC) which is the apex level inter-institutional body for financial stability in the country also includes financial inclusion.

The foundation for promoting greater financial access in the country can be traced to the findings of the all-India Rural Credit Survey in the early 1950s. The findings of the Survey indicated that, out of the total borrowings of farmers in 1951–52 estimated at Rs. 7.5 billion, commercial banks provided less than one per cent while moneylenders provided 70 per cent. The distribution of bank branches was also highly skewed in favour of urban and metropolitan/port centres in 1969. Even in terms of distribution of bank credit, the share of private corporate business exhibited an overwhelming increase, from 44 per cent during 1957–61 to over 60 per cent for the quinquennium ending 1969[14].

These disturbing features brought out by the survey culminated in the process of nationalization of major public sector banks with a view to leveraging the banking system as a tool for promoting a slew of social objectives of which inclusion was one. The initiatives in this direction included the requirement that banks could open a branch in a location with one or more branches only if they had opened four in a location with no or a few branches. The branch licensing policy of the Reserve Bank of India has undergone a sea change since then in terms of liberalisation but the cornerstone of the policy, till date, remains one of encouraging banks to open an increasing number of branches in the less banked regions of the country by linking of the regulatory framework for opening branches to, *inter alia*, penetration in un-banked areas. The extensive branch network of many Indian banks have today provided them with a strong base of stable core deposits – widely recognised as a critical element for the resilience of the banking system to the headwinds of any financial instability.

Mandated priority sector lending (40 per cent of lending in case of domestic banks and 32 per cent in case of foreign banks) was another policy initiative aimed at ensuring flow of affordable credit to the less privileged sections and segments. Importantly, there is no interest subvention involved in the lending by the banks to priority sectors (except for the insignificant percentage of loans extended under the Differential Rate of Interest scheme to

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13 On December 2, 2011, Reserve Bank of India has issued a circular wherein a new category of NBFC – Non Banking Financial Company – Micro Finance Institutions has been introduced. The regulatory directions for NBFC-MFIs have also been issued along with the circular.

14 "Financial Inclusion and Financial Fragility: An Empirical Note", S. Ghosh, 2008.

the most disadvantaged people and Government's interest subvention in respect of agricultural loans). The usual norms of capital adequacy, asset classification and provisioning apply to such lendings, implying thereby that the quality of the credit portfolio was to be maintained and the soundness of institutions was not compromised with even as financial inclusion was promoted.

The concept of no frills accounts with low or zero minimum balance was introduced in 2005 to enable a larger section of the poor and under-priviledged section. Simpler KYC norms were introduced for this section of society with a view to ensuring that people without documentary proof of address and /or identity are not deprived of banking facilities while at the same time ensuring that the minimum requirement for the proper identification of each customer is complied with. The recently introduced "Aadhar" project by the Unique Identification Authority of India (UIDA) will, by providing a clear proof of identity for all residents, pave the way for the entry of under-priviledged citizens into the formal banking system within the ambit of prevalent regulation.

Following the recommendations of the Khan Committee, Reserve Bank of India paved the way for branchless banking (through the business correspondents/Business facilitator model) in 2006 in recognition of the fact that it would be difficult to provide access to banking facility for every household in around 600,000 villages in the country through brick & mortar branches. Simultaneously, sufficient safeguards in the form of biometric identification of customers, guidelines for the appointment and functioning of agents, including stipulation of distance criterion from a base branch, same or next day accounting of customer transactions and adherence to the risk mitigation norms for outsourcing of activities have been put in place from the perspective of consumer protection to address the risk of reckless selling of products and services by agents working to earn commission.

Non-banking and non-financial entities have been permitted into the financial inclusion space in a calibrated manner largely to help banks in offering customized payment and remittance services to customers with adequate safeguards. Payment services operated by the non-banks were brought under regulation of the Reserve Bank of India after the notification of the Payment and Settlement Systems Act, 2007 and the broad approach has been that these entities will provide fee based services without obtaining access to customer funds (for example, mobile wallets provided by non-banks through the mechanism of the escrow account with a bank).

The Self Help Group-Bank Linkage Program introduced in the 1990s facilitated the formation of tremendous synergies between the formal financial sector and the informal sector. Provision of banking services to the poor households was achieved without relaxation of capital adequacy and other prudential norms for microfinance entities and other institutions.

Consumer protection issues have remained at the forefront even as the drive for financial inclusion remained at the top of the Reserve Bank of India's policy agenda. In 2005, the Reserve Bank facilitated the establishment of the Banking Codes and Standards Board of India (BCSBI) in order to ensure that a comprehensive code of conduct for fair treatment of customers is evolved and the adherence of banks to the code is monitored on a continuous basis. Recent initiatives have focused on the reports of excessive/usurious interest rates being charged by the MFIs in a non- transparent manner/ and other questionable practices/processes including coercive recovery methods. A regulatory framework aimed at MFIs is being contemplated by the Reserve Bank of India and will be issued shortly[15]. A comprehensive financial literacy programme aims to equip the hitherto unbanked and unaware to make best use of the increasing access to financial services, even as the Banking Ombudsman System has been established to provide a forum for grievance redressal. In fact, the cornerstone of the Reserve Bank's Platinum Jubilee celebrations in

[15] Refer to footnote 11.

2009–2010 was an outreach programme aimed at educating low income groups, preferably in the remote areas, to demand financial services and at encouraging banks to supply financial services needed by the poor. The initiative continues to be an ongoing endeavor well after the completion of the Platinum Jubilee year.

Recent policy initiatives to drive financial inclusion, including formulation of a board approved Financial Inclusion Policy (FIP) by the banks, also attempt to strike a balance between the requirements of financial inclusion and that of soundness of financial institutions and stability of the financial system.

The Malegam Committee has made a series of recommendations to address reports of excessive interest rates, over-borrowing, ghost borrowers and coercive recovery practices in the microfinance sector. Some of these recommendations have been implemented and will aid in ensuring that the industry continues to play a facilitative role in achieving greater financial inclusion[16].

The Business Correspondent/Business Facilitator (BC/BF) model of branchless banking has been introduced as a possible solution to overcome barriers of geography posed for financial inclusion. For success of this model it has been envisaged that appropriate technology need to be adopted on a sufficiently large scale to make the system viable and fail proof. While suggesting that alternative delivery channels need to be explored and adopted to expand the banking outreach, the Reserve Bank of India has advised banks to not to lose focus on brick & mortar structures in unbanked villages. These structures could represent simple low cost intermediate entities comprising minimum infrastructure for operating customer transactions and supporting up to 8–10 BCs at a reasonable distance of 2–3 kms. This will lead to efficiency in cash management, documentation and redressal of customer grievances. This will also provide a supervisory mechanism over the operations of the BCs/BFs. Another very important aspect that is being impressed upon the banks is that for the BC/BF model to succeed, the agents, who are the first level of contact for customers, have to be compensated adequately so that they too see this as a business opportunity for reasonable earnings and do not indulge in unethical practices.

The wide range of policy initiatives undertaken in the country has yielded rich dividends and there has been tremendous progress in bringing an increasingly growing share of the populace closer to financial systems. Over 50,000 villages with a population of over 2000 are covered by banking services and nearly 75 million no frills accounts have been opened till March 2011. A recent Reserve Bank Working Paper[17] arrived at an index of financial inclusion (IFI) as a measure of financial inclusion for the country using data on three dimensions of financial inclusion viz. banking penetration, availability of banking services and usage. Based on data from 2006–07 to 2009–10, the paper categorised the majority of Indian states as states with low levels of financial inclusion. These findings are confirmed by empirical evidence. As per recent statistics, only 57 per cent of the population has a bank account and only 30,000 of the 600,000 habitations in the country have a commercial bank branch. As against this, in UK three per cent of households are unbanked, in Sweden less than two per cent of the adult population did not have an account in 2000, in Germany, the figure was around three per cent and less than four per cent of adults in Canada and five per cent in Belgium lacked a bank account. A lot therefore needs to be achieved further in order to realize the goal of inclusive growth with stability. In particular, we should also not lose focus that financial inclusion is part of the wider concept of economic inclusion and that effective risk mitigants have to be in place while we pursue the financial inclusion objectives vigorously so that the efforts are viable and sustainable overtime.

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[16] Refer to footnote 4.

[17] RBI WP series no. 8/2011 “Financial Inclusion in India” by S K Chattopadhyay.

Concluding thoughts

Let me now conclude with a few final observations.

Financial inclusion is the key to inclusive growth with its motto of empowerment of poor, underprivileged and low income/skilled rural/urban households. Amartya Sen[18] convincingly argued that poverty is not merely insufficient income rather the absence of wide range of capabilities, including security and ability to participate in economic and political systems. Financial inclusion is designed to bring about the capability to participate and contribute among the economically and socially excluded people by creating equal opportunities.

Achieving sustainable financial inclusion will require a systemic effort which leverages technology, viable business models and appropriate regulatory framework cohesively. While further research is needed to better understand the transmission channels and potential feedback loops between financial stability and financial access and to identify policy solutions aiming to balance both objectives in a sustainable manner, it is evident that financial inclusion and financial stability need to coexist. The Indian experience has proved that financial inclusion can work within the framework of financial stability given an enabling regulatory environment. Also providing testimony to this are the experiences of a host of other countries, some of which I have briefly described earlier. A combination of viable business strategies targeted towards the population at the bottom of the pyramid, lower transactions costs with technological innovations and appropriate regulatory environment have helped foster greater financial inclusion with stability. The twin objectives of financial stability and financial inclusion are arguably two sides of a coin but it is imperative that a robust risk-mitigating framework which exploits their complementarities while minimising the conflicts is adopted to ensure that they do not work at cross purposes.

[18] Sen, Amartya, (2000): “Development as Freedom”, Anchor Books, New York, 2000.