FINANCIAL INCLUSION IN INDIA
Issues and Challenges

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ABSTRACT

Access to finance by the poor, disadvantaged and underprivileged group is a prerequisite of poverty alleviation on one hand and the economic growth on the other. In the struggle against poverty, the financial inclusion is a crucial element. Large sections of the rural population have no access to financial services and their only recourse is to borrow from moneylenders at the exorbitant charges causing exploitation. The main reason why the large section of the rural population still remains under below poverty is financial exclusion, which is proving to be a major obstacle in the path of India's economic growth. The Reserve Bank of India (RBI)'s dictate (2005) obligated the Banks to adopt the national policy of financial inclusion and take initiatives and suitable measures therefore. The objective data derived from the RBI's reports and other empirical studies unequivocally pinpoint that the main reasons of financial exclusion are lack of opportunities and access to finance, financial illiteracy, besides poor performance, apathy and negative approaches of the Banks. Therefore, financial inclusion, today, has become the national objective and major concern for the economic policy decision makers. This paper critically addresses all concerned issues involved in achieving the national objective of achieving the complete financial inclusion. This paper critically evaluates the initiatives taken by the Banks in financial inclusion and the efforts made for IT enabled financial services, on the basis of the objective data derived from the RBI'S reports and other empirical studies.

This paper stresses the need of matured, positive attitude and approach and sound strategy to achieve complete financial inclusion. This paper also looks at some of the business models and essential elements of profitable models for financial inclusion so as to increase the meaningful and whole hearted participation of the banks in achieving complete financial inclusion.

Keywords: Poverty alleviation, financial exclusion, financial illiteracy, Financial Inclusion, RBI, Information Technology, Business and Profitable models.

I. INTRODUCTION

Financial exclusion is the main cause of poverty. Lack of opportunities and access to finance besides financial illiteracy are the main causes of financial exclusion. Financial exclusion is proving to be a major thorn in the path of Indian economic growth. Access to finance by the poor, disadvantaged and unprivileged group is a prerequisite for poverty reduction and social upliftment. One of the main reasons why the large section of the rural population still remains under below poverty line is lack of opportunities and access to finance besides financial illiteracy. Large sections of the rural population have no access to financial services and their only recourse is to borrow from money lenders, who charge exorbitant rates. Also, ignorance is rife, with concepts like insurance virtually unheard of. One of the main reasons why mass poverty is persisting in India is that the problem of financing the poor still remains unresolved (RBI, 2011a). With almost all states show more than 60% of populations below the poverty line. Projections based on NSSO data present a disturbing picture as population cut offs for average consumption for almost all states fall between the sixth and seventh deciles, statistics for which are available in its report "Key Indicators of Household Expenditure in India." (Sunday Times, 2012).

II. FINANCIAL EXCLUSION

Nature, Causes, Costs and Consequences of Financial Exclusion

Financial exclusion is broadly defined as the lack of access by certain segments of the society to suitable, low-cost, fair and safe financial products and services from mainstream providers. Thus the essence of financial inclusion is to ensure that a range of appropriate financial services is available to every individual and enable them to understand and access those services. Apart from the regular form of financial intermediation, it may include a basic no frills banking account for making and receiving payments, a savings product suited to the pattern of cash flows of a poor household, money transfer facilities, small loans and overdrafts for productive, personal and other purposes, insurance (life and non-life), etc. (Chattopadhyay, 2011).

III. ACCESS TO FINANCE: CONCEPTUAL FRAMEWORK

Concept and Definition of Financial Inclusion

The term 'Financial Inclusion' was first coined in British lexicon when it was found that nearly 7.5 million persons did not have a bank account. Defining financial inclusion is considered crucial from the viewpoint of developing a conceptual framework and identifying the underlying factors that lead to low level of access to the financial system (Raju, 2006).

Indian Approach to Financial Inclusion

Broadly, the policy approach adapted to financial inclusion in India can be divided in two categories - the minimalist approach and the expanded approach :- (a) The **minimalist approach** for financial inclusion focuses on the provision of a bouquet of basic financial products and services; whereas, (b) The **expanded approach** for financial inclusion focuses not only on the provision of the basic banking products but also other important ancillary financial products, which would also entail focus on consumer protection and education, particularly financial literacy for the new entrants to the formal financial system (Khan, 2012).

Importance of Financial Inclusion

In majority of the developing countries, access to finance (Khan, 2012) is now being perceived as a public good, which is as important and basic as access, say, to safe water or primary education. A question that arises is whether financial inclusion can be interpreted as a public good. A good is considered a public good if it meets the conditions of (a) 'non-rivalness' in consumption and (b) non-excludability. Financial inclusion meets these two criteria. One of the important effects of financial inclusion is that the entire national financial system benefits by greater inclusion, especially when promoted in the wider context of economic inclusion.

Financial Inclusion and Inclusive Growth:

Inclusive growth as a strategy of economic development has received renewed attention in recent years owing to rising concerns that the benefits of economic growth have not been equitably shared. Growth is inclusive when there is equality of economic opportunities. Financial inclusion makes growth broad based and sustainable by progressively encompassing the hitherto excluded population. Financial inclusion is no longer a policy choice but a policy compulsion (RBI, 2011b). Empirical evidence shows that countries with large proportion of population excluded from the formal financial system also show higher poverty ratios and higher inequality. The inclusive growth country analytics has a distinct character focusing on the pace and pattern of growth. The progress of financial inclusion plans in India as on March 31, 2012 is depicted in Table I.

Table I Progress of Financial Inclusion Plan in India (as on March 31, 2012)

Banking outlets	
Rural branches	24701
BC outlets	120355
Other modes	2478
Total	**147534**
Total number of 'No frill accounts'	**103.21 million**
	(increase of 39.6%)
Operations in NFA (2011-12)	
Outstanding balance	**Rs. 932.89 billion**
Overdrafts	**Rs. 3.39 billion**
Transactions through ICT based BC outlets (2011-12)	**119.77 million**
KCC credit	**Rs. 2.15 million**
GCC credit	**Rs. 0.22 million**

Source : Khan (2012)

IV MAJOR ISSUES and CHALLENGES in FINANCIAL INCLUSION

There are several issues, challenges and strategies to achieve the target of complete financial inclusion; however, for restricting to the theme of the paper and space constraints, only major issues, challenges *vis-à-vis* strategies have been dealt with.

1. **Change in the approach of Banks: Only access to credit or banking is NOT the financial inclusion: Achieving complete Financial Inclusion:** It is often noticed that mere opening a Bank Account is taken or claimed as achieving the target of financial-

inclusion. Many empirical studies and Usage Analysis reveal that after opening such bank accounts, hardly there are any transactions take place in such bank accounts. Banks must genuinely strive to provide the directed services under the category or scheme of financial inclusion to the rural population, since they are the main pillars for the desired success.

2. **Relaxation in Regulatory Framework:** The RBI, initially, in November 2005, set the population benchmark, which will help it, for taking its financial inclusion drive to the next level, mandating all Banks to reach out the villages, all habitations with population in excess of 2000, as per the 2001 census, either through the Bank Branches or through Business Correspondent (BCs). However, since 2011-12, the population benchmark is reduced to 1600 and above. Very recently, on 11 August 2012, the RBI asked Banks to drop the 'no-frills' tag from the basic savings accounts as the nomenclature has become a stigma. The RBI asked Banks to provide the 'zero-balance' facility in the basic banking accounts along with ATM-cum-Debit Cards without extra charge. The Finance Ministry directed the Banks were directed to reach out to villages with population of 2000, as the population benchmark that all habitations with population in excess of 1600 must have a bank branch, which will help it take its financial inclusion drive to the next level. The Finance Ministry, very recently, directed all state-run Banks to ensure that every household has at least one savings bank account by end of June 2012, a move seen as a precursor to direct transfer of benefits under the government's financial inclusion plan. For this purpose, the Banks have been asked to launch a campaign to ensure that opening of new accounts and changes required in existing accounts are completed by June 2012, (Khan, 2011).

3. **Self Help Group-Bank Linkage Programme (SLBP):** In the last two decades, the major institutional innovation in India for expanding financial system access and usage for the poor and marginalized sections of the population has been the SBLP. The project provided a cost-effective SBLP model for providing financial services to the underserved poor. Being a 'savings-first, credit later' model, credit discipline became a norm for Self Help Groups (SHGs) and 'social collateral' made them bankable. The model was initially successful in providing solution to the twin problems faced by banks, i.e., low recovery of loans in rural areas and high transaction costs in dealing with small borrowers at frequent intervals, with a major positive impact of generating social and economic empowerment of the membership. However, despite the noteworthy accomplishments of SHGs certain issues, such as, inadequate outreach in many regions, delays in opening of SHG accounts

and disbursement of loans, impounding of savings by banks as collateral, non-approval of repeat loans by banks even when the first loan was repaid promptly, multiple membership, borrowings by SHG members within and outside SHGs, adverse consequences of unhealthy competition between NGO promoted SHGs and Government promoted/subsidy oriented SHGs and limited banker interface and monitoring continued to affect the programme in many areas. While the basic tenets of the SHGs being savings led credit product remain true even today, recent developments have given rise to the need for crucial changes in the approach and design of SBLP to make it more flexible and client friendly. The revised NABARD guidelines, popularly known as SHG2 (version 2), have sought to address some of the shortcomings of the earlier version, (Khan, 2011).

4. **Microfinance Institutions (MFIs):** The MFIs have served the underserved/unserved populace in the last few years and improved access to credit though there have been quite a few debatable issues on the style of corporate governance and ethics of conducting business on part of some of the MFIs. However, it has been often realized that the MFIs do help in financial deepening and can remain an important segment of the Indian financial market keeping in view the present level of penetration of the banking system. The conceptual framework underlying MFIs requires a change. MFIs will have to revisit the mission and business strategy and reinvent the sector to remain relevant in the system. A new category of 'Non Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) prescribed by the Malegam Committee (2011), created in December 2011 by RBI, is also facing difficulties primarily into micro financing. The NBFC-MFIs has got some relief from the RBI, which issued revised 'Directions cum Modifications' in August 2012, (RBI, 2012). On this background, these institutions have to revisit their business models to support the income earning ability of the borrowers and, at the same time, they remain economically viable. NBFC-MFIs will have to work hard in pursuit of transparency and responsible finance, shaking off the perception that their motto is profiteering at the cost of the poor but not profitability for sustainable and viable growth on one hand and take initiatives to retool the product redesign for garnering new customers and acquiring more share of the market on the other (Khan, 2011).

5. **Business Facilitators (BFs)/Business Correspondents (BCs):** The ICT based agent bank model through BFs/BCs for ensuring door step delivery of financial products and services, prescribed by the RBI to act as intermediaries for providing financial and banking

services and ultimately addressing the proverbial last mile problem, initially created by the banks themselves, and later improvised by number of innovations, bridging the connectivity gap between the service seekers, i.e., under-served populace, and the service providers, i.e., the banks, have, however, raised a number of issues both for the partner banks and also for the regulators. Viability of the BFs/BCs model in general has remained a critical issue for which the model has not taken off as expected. Further, banks and their BFs/BCs also exposed to huge risk of cash management, particularly as cash dependence of the economy continues to be very high. There is also huge requirement of hand-holding and training of the BFs/BCs to enhance the trust level of the end customers. In this context, the current thinking of having lean, brick and mortar outfits of the banks (e.g. ultra small branches) to provide support to and supervise work of certain number of BFs/BCs appears to be a step in right direction. **The success of BFs/BCs model also hinges on adoption of technology, which in turn, is dependent on the degree of compatibility and integration of technology being used by the banks and their BFs/BCs**. There is a view that banks could also have their in-house BF/BC outfits in the form of separate trusts/subsidiaries with separate recruitment and remuneration structure but under closer supervisory control.

6. Customer service and consumer protection: Customer service is another issue that needs closer attention. Mind-set, cultural and attitudinal changes at the grass-root levels and user friendly technology at the level of branches of banks and BC outlets are needed to extend holistic customer service to the new entrants to the banking system. Government, regulators like Reserve Bank of India, banks, service providers and consumers themselves have to play important role in developing a comprehensive approach to consumer protection (Khan, 2012).

7. Issues and Challenges in ICT based Financial Services: Tapping Technology Platforms: Banks need to make significant investments in Technology based applications, related research and development efforts, comprehensive Management Information Service (MIS) and monitoring and evaluation systems on one hand and **collaborate** with technology service providers (TSPs), mobile network operators (MNOs), corporate houses and various categories of BCs to develop efficient delivery models with a strategy aiming to create a facilitating eco-system, leveraging on technology and promote partnerships of brick and mortar branches including ultra-small branches with the ICT-based BC outlets for evolving an effective financial inclusion delivery mechanism.

8. **Financial Inclusion** as a **Business Opportunity** *vis-à-vis* **Profitable Models for Financial Inclusion:**

Financial inclusion initiatives would provide banks with a low-cost and stable source of funds, helping them improve their asset-liability management (ALM). Rural India presents a remarkable opportunity for banks and financial institutions to seek their fortunes and bring prosperity to the aspiring poor through financial inclusion. In a fast growing economy like India the poor are the middle class of tomorrow and banks could, therefore, ill-afford to ignore this segment. Banks, however, argue that while the benefits of financial inclusion can be easily understood, the costs of serving the poor can be significant in the short-term, thereby impacting profitability. Banks, therefore, need to take bold decisions and reach out to rural India with strategies and business models which are beyond the realm of conventional thinking. Banks should refrain from deliberately adopting a uniform business model. Banks need to build its own strategy in line with its business model and comparative advantage.

A successful model should also represent a better way than existing alternatives and also answer management guru Peter Drucker's age-old questions: (a) **Who is your customer?** (b) **What does the customer value?** & (c) **How do you deliver value at an appropriate cost?** A (Ramon, 2011) profitable business model should consist of four elements: • **a customer value proposition • a profit formula • key resources • key processes.**

Profitable models for financial inclusion could, therefore, have the following features* *(*Note: These are concluding compilation of various options guided/suggested on this theme to the banks by various authorities, viz., RBI-2008, RBI-2011a, RBI-2011b, RBI-2011c, RBI-2011d, NABARD-2012; and also by various experts and authors on this theme, including : Chaia et al.-2010, Khan-2011, Karmakar-2011, Nadkarni-2012, Nair-2012, Rabha, 2012, Raj-2011,Ramon-2011)***:**

(a) Offering a clear customer proposition and customized bouquet of products**:-** To succeed in their financial inclusion initiatives, banks would need to offer customers a clear proposition and a customized bouquet of product offerings. Banks need to offer the following services at a minimum costs and charges, as part of an overall **'package'** to attract customers:-

- Advice on monetary issues, problems, needs and plans
- Savings cum Overdraft account;
- Remittance-products;
- Kisan Credit Card/General Credit Card
- Disbursements of Grants & Financial Assistance awarded by & in accordance with the Central Govt., State Govt., Local authorities, other Funding agencies, NGOs, etc.;

- Micro-Credits as per Bank's own schemes;
- Govt. directed Priority sectoral lending
- Entrepreneurial Credit
- Micro-Insurance.

-Each of these offer significant value to customer and enable banks to generate value through transaction fees.

(b) Scalable business model with simple, user friendly low-cost technologies:- Profitable business models, (Raj, 2011) would need to be scalable and incorporate simple, user-friendly and low-cost technologies so that investments would be recouped and profits begin showing up as the number of people serviced by a particular branch or outlet increases over time.

(c) Collaborate with local agents and for-profit companies:- According to consulting giant (Raj, 2010 from Chaia *et al.*, 2010), the basic problem of 'last mile access' can be solved if banks can team up with retail outlets (business correspondents) in low-income, often hard-to-reach areas to offer financial services to rural masses, thereby, creating value both for themselves and their customers.

(d) Banks need to learn from both corporate India and the informal sector:- Banks need to innovate and improve service levels in order to provide the same level of accessibility as the local money lender, friend or relative and open branches/banking outlets in villages as inclusive banking goes beyond the conventional notions of commercial banking.

(e) Subsidiary model to drive down costs**:-** Indian banks should explore the subsidiary route to drive down distribution costs in their financial inclusion drive.

(f) Strategy to gain benefits from Government scheme of MGNREGA :-, Banks need to mould their strategies to gain benefits amendments made in August 2011 making mandatory under the law for state governments to ensure that every beneficiary of the MGNREGA scheme has a bank/post office account and the disbursements are made exclusively through these channels, which provide opportunities to the banks and positively benefit financial inclusion initiatives.

(g) Innovate and test-market pilot products/services:- Banks need to keep their MIS updated and keep ground realities in mind while designing their products/services for the poor. McKinsey's report (2010) also suggests that financial service providers should test-market low-cost pilots to see which products/services are found acceptable before large-scale introduction.

VII CONCLUSION

The problem of financial exclusion needs to be tackled with urgency if we want our country to grow in an equitable and sustainable manner. Traditional and conventional banking solutions may not be the answer to address the problem of financial inclusion in India. Banks, therefore, need to innovate and think 'out-of-the-box' for solutions to overcome the problem of financial exclusion in India. They need to deploy new technologies and create financially viable models to take forward the process of financial inclusion in an effective manner. This way banks in India would be doing a great service to the cause of financial inclusion and make their name in history. Financial inclusion may be a social responsibility for the banks in the short-run but will turn out to be a business opportunity in the long-term. Financial Inclusion is no longer an option, but it is a compulsion. The entire world is looking at this experiment in India and it is important that banks rise up to this challenge and meet it successfully. The current policy objective of inclusive growth with financial stability cannot be achieved without ensuring universal financial inclusion. Pursuit of financial inclusion by adoption of innovative products and processes does, however, pose challenge of managing trade-offs between the objective of financial inclusion and financial stability. In the Indian context, the Reserve Bank has always sought to balance the risk of partnerships and product innovations with the ability to achieve greater penetration in a safe, secured and prudentially sound manner. The underlying belief is that only sound and strong institutions can promote financial inclusion in a sustainable manner and, towards this end, prudent regulations have to be in place to achieve inclusion while protecting financial stability and consumer interest. By adopting appropriate regulatory framework for innovations in policies, partnerships, processes and products meant for financial inclusion, the Reserve Bank has sought to further the cause of inclusion without falling short of the policy goal of financial stability. The stakeholders have come to realize the need for viable and sustainable business models which focus on accessible and affordable financial services, products and processes, synergistic partnerships with non-bank entities including the technology service providers for efficient handling of low value, large volume transactions, particularly in remote, banking shadow areas and appropriate regulatory and risk management policies that ensure financial inclusion and financial stability move in tandem.

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