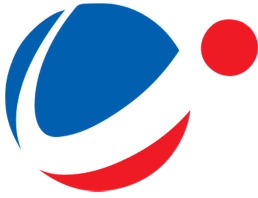

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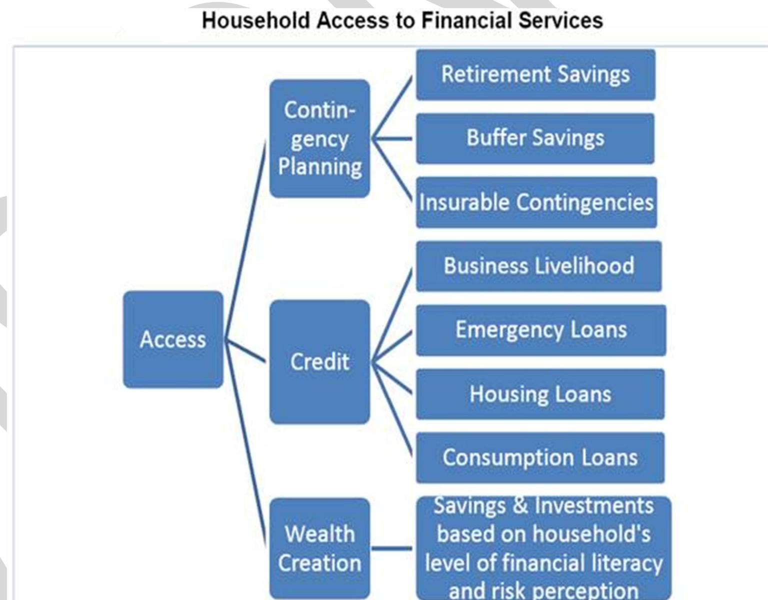
Financial Inclusion

1 Introduction

Financial inclusion may be defined as the delivery of banking services at an affordable cost, especially to the vast sections of disadvantaged and low-income group. In other words, it is 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.

Since, unrestrained access to public goods and services is the sine qua non of an open and efficient society, and banking services are in the nature of public good, therefore, it is essential that availability of banking and payment services to the entire population, without discrimination, be the prime objective of the public policy. Household access to financial services can be depicted as under:

Household Access to Financial Services



Source: A Hundred Small Steps - Report of the Committee on Financial Sector Reforms (Chairman : Dr. RaghuramRajan).

The essence of financial inclusion is to ensure delivery of financial services, like - bank accounts for savings and transactional purposes, low cost credit for productive, personal and other purposes, financial advisory services, insurance facilities (life and non-life) etc.

2 Constraints to Financial Inclusion

- The three big challenges are- high cost, lack of robust technology, and lack of awareness.
- The banks are faced with high operating cost in extending the financial services to the remote areas. High maintenance cost of these accounts as well as small ticket size of the transactions is also adding to the problem.

3 Extent of Financial Exclusion in India

(a) According to World Bank's Global Financial Inclusion Survey (2012), only 35% of adults in India had access to a formal bank account and only 8% borrowed from institutional and formal sources.

(b) As per Census 2011, only 58.7% of households are availing banking services in the country. However, as compared with previous Census 2001, availing of banking services increased significantly largely on account of increase in banking services in rural areas.

(c) According to the World Bank 'Financial Access Survey' Results, in our country, financial exclusion measured in terms of bank branch density, ATM density, bank credit to GDP and bank deposits to GDP is quite low as compared with most of developing countries in the world.

(d) The Economic Census 2005 revealed that the massive Small and Medium Enterprises (SME) sector, which provides 90 per cent of non-farming employment, could access only 4 per cent of institutionalized finance, leaving the rest to usurious money lenders. Banks in India almost monopolize national cash savings. The significance of this sector lies in the fact that about two-third unit in SME sector are owned and operated by the disadvantaged section of the population, like SCs, STs, and OBCs.

(e) Agriculture not only plays the central role for achieving high growth but also inclusive growth for the economy as a whole (generates about 20 per cent of India's GDP and provides employment to nearly two-third of its population). However, a very large segment of agricultural sector is starved of formal credit, forcing the farmers to borrow from the informal moneylenders at usurious interest rates. This sets a cycle of indebtedness.

(f) At present, only about 5% of India's 6 lakh villages have bank branches. There are 296 under-banked districts in states with below-par banking services.

4 Consequences of Financial Exclusion

(a) The severity of the consequences of financial exclusion will depend to a large extend on the prevailing level of financial exclusion in a country. The more a country is financialized, the more people who have no access to financial products face difficulties and will suffer from important financial, economical and social consequences.

(b) Accepting a job can be more difficult, if there is widespread financial exclusion, as most employers insist on paying wages electronically into an account. Getting access to other financial products (insurance, credit) may depend on being able to pay by direct debit and not having a bank account also reduces credit scores.

(c) In the face of widespread financial exclusion, for the affected people the only option in times of need is illegal lenders. Such lenders apply default charges that can be extortionate and arbitrary. Consequently, many borrowers can never settle their loan in full and the vicious cycle of perpetual indebtedness sets in. In the worst cases, failure to pay can mean customers being forced to deal in drugs or into prostitution on behalf of the lender, and the ultimate option is self killing-The cases of farm suicide in some regions of India are a pointer to this fact.

(d) A much wider problem, however, relates to people using the sub-prime credit market, where terms and conditions are inferior to those in the prime market and costs are higher. Self-evidently people who lack savings have no way to deal with income shocks or emergencies other than borrowing. Further, people who save informally (that is not in a bank account) do not benefit from the interest rates and tax advantages that people with savings accounts enjoy. Finally, savings kept in cash at home are vulnerable to theft.

(e) If some of the sectors of the economy, like the SMEs sector, are affected by financial exclusion then their potential contribution to the overall economic growth is severely hampered. Further, given the fact that about two-third of the units in this sector are owned by the disadvantaged section, such an exclusion results into a form of social injustice.

(f) Financial inclusion broadens the resource base of the financial system by developing a culture of savings among large segment of rural population and plays its own role in the process of economic development. Further, by bringing low income groups within the perimeter of formal banking sector; financial inclusion protects their financial wealth and other resources in exigent circumstances. Financial inclusion also mitigates the exploitation of vulnerable sections by the usurious money lenders by facilitating easy access to formal credit.

5 Measures for combating Financial Exclusion

When bankers do not give the desired attention to certain areas, the regulators have to step in to remedy the situation. This is the reason why the Reserve Bank of India places a lot of emphasis on financial inclusion.

Thus, the Government of India and the Reserve Bank of India have been making concerted efforts to promote financial inclusion as one of the important national objectives of the country. Some of the major efforts made in the last five decades include - nationalization of banks, building up of robust branch network of scheduled commercial banks, co-operatives and regional rural banks, introduction of mandated priority sector lending targets, lead bank scheme, formation of self-help groups, permitting BCs/BFs to be appointed by banks to provide door step delivery of banking services, zero balance BSBD accounts, etc. The fundamental objective of all these initiatives is to reach the large sections of the hitherto financially excluded Indian population.

6 Possible way forward for promoting Financial Inclusion

- With the arrival of banking technology and realization that poor are bankable with good business prospects, financial inclusion initiatives will strengthen financial deepening further and provide resources to the banks to expand credit delivery. The banking technology initiatives meant for financial inclusion should be collaborative and innovative with an objective to reduce the transaction costs. Thus, financial inclusion along with the Governmental developmental programmes will lead to an overall financial and economic development in our country and as in the case for most developing countries, extending the banking services to everyone in the country will be the key driver towards an inclusive growth.
- There is a need for greater stakeholder coordination, greater consumer understanding, trust and protection.
- Product design is the most critical component of a viable financial inclusion strategy, for this banks and other financial service providers will have to develop a better understanding of the potential customers.

All the above measures can be categorized within the larger ambit of banking reforms. So it is important to devote some space for discussing banking reforms in some detail.

7 Banking reforms for promoting Financial Inclusion

With a view to covert banking services from the "class phenomenon" to the "mass phenomenon", the Central government nationalised fourteen major commercial banks in 1969. It was considered that banks were controlled by business houses and thus failed in catering to the credit needs of poor sections such as cottage industry, village industry, farmers, craft men, etc. The second dose of nationalization came in April 1980 when six more banks were nationalized. The broad objectives of nationalization of banks were-

- Social Welfare
- Controlling Private Monopolies
- Expansion of Banking
- Reducing Regional Imbalance
- Priority Sector Lending
- Developing Banking Habits

To further the goal of financial inclusion, the government launched the Lead Bank Scheme in 1969 itself. It was based on the recommendation of the Gadgil Study Group. The basic idea was to have an "area approach" for targeted and focused banking. Under the scheme a cluster of villages were to be allotted to public sector banks for serving to their credit needs.

Thus, the RBI has adopted a bank-led model for achieving financial inclusion and removed various regulatory bottle necks in achieving greater financial inclusion in the country. Further, for achieving the targeted goals, RBI has created conducive regulatory environment and provided institutional support for banks in accelerating their financial inclusion efforts. In more specific terms, following were some of the initiatives taken by the RBI for promoting Financial Inclusion in the country-

(a) **Priority Sector Lending:** It is an important role given by the Reserve Bank of India (RBI) to the banks for providing a specified portion of the bank lending to few specific sectors like agriculture or small scale industries. This is essentially meant for an all round development of the economy as opposed to focusing only on the financial sector.

(b) **Setting up of the "Ultra Small Branches":** These are non brick-mortar branches, the purpose of which is to reduce the infrastructural costs in setting up branches in rural areas. Under this initiative, the banks will appoint banking correspondent who will deal with all cash transactions and other routine work in that area. A bank officer will visit this ultra small branch once a week and connect this business correspondent to the banks' core banking solution (CBS) through a secured network enabling data access and transfer between the small branch and the bank.

(c) **Opening of no-frills accounts:** Basic banking no-frills account is with nil or very low minimum balance as well as charges that make such accounts accessible to vast sections of the population. Banks have been advised to provide small overdrafts in such accounts.

(d) **Relaxation on know-your-customer (KYC) norms:** KYC requirements for opening bank accounts were relaxed for small accounts in August 2005; thereby simplifying procedures by stipulating that introduction by an account holder who has been subjected to the full KYC drill would suffice for opening such accounts. It has now been further relaxed to include the letters issued by the Unique Identification Authority of India containing details of name, address and Aadhaar number.

(e) **Engaging business correspondents (BCs):** In January 2006, RBI permitted banks to engage business facilitators (BFs) and BCs as intermediaries for providing financial and banking services. The BC model allows banks to provide doorstep delivery of services, especially cash in-cash out transactions, thus addressing the last-mile problem.

(f) **Use of technology:** Recognizing that technology has the potential to address the issues of outreach and credit delivery in rural and remote areas in a viable manner, banks have been advised to make effective use of information and communications technology (ICT), to provide doorstep banking services through the BC model where the accounts can be operated by even illiterate customers by using biometrics, thus ensuring the security of transactions and enhancing confidence in the banking system.

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(g) **General-purpose Credit Card (GCC):** With a view to helping the poor and the disadvantaged with access to easy credit, banks have been asked to consider introduction of a general purpose credit card facility up to Rs 25,000 at their rural and semi-urban branches. The objective of the scheme is to provide hassle-free credit to banks' customers based on the assessment of cash flow without insistence on security, purpose or end use of the credit. This is in the nature of revolving credit entitling the holder to withdraw up to the limit sanctioned.

(h) **Simplified branch authorization:** To address the issue of uneven spread of bank branches, in December 2009, domestic scheduled commercial banks were permitted to freely open branches in tier III to tier VI urban centers, subject to reporting. In the north-eastern states and Sikkim, domestic scheduled commercial banks can now open branches in rural, semi-urban and urban centers without the need to take permission from RBI in each case, subject to reporting.

(i) **Opening of branches in unbanked rural centers:** To further step up the opening of branches in rural areas so as to improve banking penetration and financial inclusion rapidly, the need for the opening of more bricks and mortar branches, besides the use of BCs, was felt. Accordingly, banks have been mandated to allocate at least 25% of the total number of branches to be opened during a year to unbanked rural centers.

(j) Opening of intermediate brick and mortar structure, for effective cash management, documentation, and redressal of customer grievances and close supervision of BC operations. Banks have been advised to open intermediate structures between the present base branch and BC locations. This branch could be in the form of a low cost simple brick and mortar structure consisting of minimum infrastructure such core banking solution terminal linked to a pass book printer and a safe for cash retention for operating larger customer transactions.

(k) **The concept of differential banks:** The RBI introduced the concept of "Payment Banks" and "small banks" to attract serious players and push financial inclusion. It allowed corporate houses, including telecom players and retail chains, to set up payment banks, and also gave them the option of forming joint ventures with commercial banks. The guidelines had expanded the scope of activities for providing third-party products and services, such as mutual funds, insurance and pension. This would open avenues to earn fee income. The guidelines have also allowed sending and receiving remittances from multiple banks and international remittances and permitted payment banks to function as business correspondents of other banks. We will discuss this sub-topic in the subsequent section.

8 Present status of Financial Inclusion in India

Progress of financial inclusion, since the launch of financial inclusion plans, clearly indicates that banks are progressing in areas like opening of banking outlets, deploying BCs, opening of no-frill accounts, grant of credit through Kisan Credit Cards and General-purpose Credit Cards. In more specific terms following are some of the achievements of financial inclusion plans-

(a) Due to RBI's concerted efforts since 2005, the number of branches of Scheduled Commercial Banks increased manifold from March 2006 to March 2013, spread across length and breadth of the country.

(b) The number of banking outlets in villages with population more than 2000 as well as less than 2000 increased consistently since March 2010.

(c) The number of no-frill accounts opened increased to about 2.5 times from March 2010 to March 2013.

Despite all these initiatives, still there are millions of households which are outside the ambit of financial system. Though, the banking system has penetrated into the rural and remote areas, but still a large percentage of our villages are without any bank branches. This may be attributed to the lack of viability of operating a bank branch in such areas, lack of business opportunities for banks etc. Over the last few years a number of committees have been set up for reviewing the working of banking system in India. Three of these committees are discussed in the following section.

9 Three major committees on Banking and Money Market Reforms

9.1 Urjit Patel Committee

Expert Committee to Revise and Strengthen the Monetary Policy Framework, under the chairmanship of Urjit Patel, was set up by the RBI in September 2013. Broadly, following were the main recommendations of the committee-

(a) RBI (Monetary Policy) must target inflation only, rather than the present scenario, where the RBI focuses on multiple indicators, like- increasing employment, increasing growth, stabilizing the exchange rate etc. In this strategy, the RBI will decide a "Nominal Anchor", i.e. the CPI –to monitor inflation. Then it will fix an inflation-target, which is 2-6%, and adjust its monetary policy so that inflation remains within that range.

But why RBI should target inflation only?

- In recent years, India's inflation has been highest among all G20 countries.
- India's inflation has been higher than its trade competitors. Higher inflation means that real interest rates are decreased. This in turn makes people buy more gold, which means high Current Account Deficit (CAD). High CAD would weaken the Rupee (depreciation of Indian currency). Depreciation of Rupee would mean higher import bill and higher prices of petroleum. If petroleum prices are higher, then it would adversely impact the whole of economy and everything would become more expensive. This a vicious cycle would set in.

What are the specific targets for controlling inflation?

- The RBI has to achieve the target of 4% inflation with +/- 2% band by January 2016.
- To elaborate, RBI should reduce CPI to 8% within 1 year, i.e. January 2015. RBI should reduce CPI to 6% within 2 years, i.e. January 2016. Thereafter, RBI should try to maintain inflation within the 2-6% range. (i.e. 4% with +/-2% band). Thus, minimum inflation should be 2% and maximum 6%.

What are the benefits of this strategy?

- If inflation is controlled then other indicators of economy would automatically be corrected, like growth, employment, etc.
- Once the RBI sets an inflation target, no one can 'influence' it or put informal pressure.
- Easy to track progress, because CPI data released after every twelve days.
- Central banks in all advanced economies and emerging market economies have adopted this method.
- It brings transparency. Even common man can understand what RBI's policy is and whether it's yielding result or not? Because there is only target to monitor, i.e. CPI.

What are the possible disadvantages of this strategy?

- In CPI index- more than 50% weightage is given to food and fuel components, the price of which is very volatile and depend on such things as monsoon, external factors etc.

What are the mechanisms available to RBI for achieving this target?

- Through "Policy Rate." Repo rate under Liquidity adjustment facility (LAF) is our policy rate.
- Apart from repo rate, there is reverse repo(RR) rate, which is repo rate – minus 1%; Marginal Standing Facility (MSF) = repo rate + 1%
- Thus, the committee recommended continuing with the existing system. Further, the committee recommended that, RBI should not change this +/- 1% spread between RR-Repo-MSF (unless in extreme situation) because unpredictable policy making is not good for banking sector's own business plans and tactical projections.
- Considering the fact that RBI already uses the policy rate to fight inflation but with little success, the committee recommended that, to be effective the policy rate should be set higher than CPI.

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In other words, the committee recommends that difference between Policy rate (Repo rate) and CPI should be "positive", only then Policy rate can fight inflation.

What will be the consequences of higher interest rates?

- Banks borrow less from RBI (Because they've to pay more interest rate)
- Banks will increase their loan interest rates (because they've less new money and still want to keep profit margin same)
- Less business expansion (because less people take loans, due to higher interest rate)
- Less new jobs created
- Less income
- Less demand
- Sellers will reduce Prices of goods and services, to attract and retain customers, thus inflation would be reduced.

(b) Better coordination and data sharing between Government of India and RBI, regarding inflation control.

(c) Greater accountability of RBI in framing monetary policy: There should be a Monetary Policy Committee, consisting of five members, with RBI governor as it head. Out of these five members, 2 must be outsiders. This committee should be responsible for framing of monetary policy, instead of present scenario where only the RBI governor is the sole authority. Further, the committee recommended that the decisions in this committee should be taken by voting.

(d) The Government of India should take fiscal consolidation measures so that the monetary policy is effectively transmitted in the economy. At present, RBI Makes monetary policy to control money supply in the system. But RBI's monetary policy fails to yield result because of government's policies and subsidies.

(e) Create standing deposit facility (similar to MSF.)

(f) Reduce SLR rate as per Basel III framework (Nachiket Committee recommended removal of SLR completely).

(g) Government's cash and Debt management function should be under a separate Government body (and not with RBI).

(h) Government should not give directives to public sector banks on interest rates.

9.2 P.J Nayak Committee

The Committee to Review Governance of Boards of Banks in India, under the chairmanship of P.J. Nayak, was set up by the RBI, to review the governance of Board of Banks in India. The committee reviewed the working of banks, especially public sector banks (PSBs) and submitted its report in May 2014. Broadly, the committee found that the root cause of inefficient functioning of PSBs is that the government owns more than 50% shares and thus interferes in sound functioning of banks. Therefore, the committee recommended the reduction of government's shareholding. The following were the main recommendations of the committee-

(a) The committee recommends the Government to repeal some of the following laws, like Bank nationalization Act (1970, 1980), SBI Act, SBI subsidiaries Act etc. It is because these acts require Government to keep shareholding more than 50%, and appoints CMDs and board directors.

(b) Once those acts are repealed, the Government should setup a Bank Investment Company (BIC), under Companies act, 2013, as a "Core investment company". BIC would have functional autonomy. Government should transfer its shares of PSBs to BIC. Register all PSBs as 'subsidiary companies' of BIC, under Companies act. (Because now BIC owns more than 50% shares in those company, so BIC is the parent "Holding" company and those banks became BIC's subsidiary companies).

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What would be the implication of this?

- BIC will have the voting powers to appoint Board of directors and other policy decision.
- Government will sign an agreement with BIC, promising it the autonomy.
- This is not an entirely new concept. In UK, Government has setup UKFI (UK Financial investment Ltd.) for the same purpose.

(c) A temporary Bank Boards Bureau (BBB) at Mumbai:

- When Bank investment company (BIC) will own more than 50% shares in PSBs, it'll have the power to appoint Board of directors (and via them appoint the CMD).
- But this requires repealing some acts, which is a time consuming exercise because parliament sessions.
- But, we can't wait that long, because Syndicate bank scam requires quick reform.

Therefore, Nayak recommends following temporary solution:

- Until BIC is born, Government should setup a Bank Boards Bureau (BBB) at Mumbai.
- This BBB will be made up of senior bankers.
- They'll advice on all board appointment, bank chairman/CMD and Executive directors.
- Once BIC is setup, this BBB will be dissolved.

(d) The committee also made recommendations on age and tenure of members of Board of Directors, CEO etc.

Why the recommendations of Nayak Committee should be implemented? Because-

(a) These would increase competitiveness of the PSBs, thereby will improve the efficiency and the quality of services provided by the PSBs.

(b) At present the PSBs are subjected to supervision by multiple agencies, like CVC, CAG, CBI, RTI etc. apart from RBI. Whereas the private banks are subjected to the supervision only of the RBI. This in turn increases the risk aversion in the PSBs. Therefore, if these recommendations are implemented then the PSBs would be on par with private banks in terms of supervisory restrictions.

(c) The PSBs suffer from "Fiscal Repression", which is a case wherein the PSBs have to invest in Government securities (G-Sec). The interest on G-Sec at present is only 8%, therefore their earning is less when compared with private banks. Private Banks do no invest in G-Sec except for SLR requirement. To stop this phenomenon government's shareholding must be reduced below 50%.

(d) At present the PSBs have to bear the burden of reckless government expenditure on loan waivers and bailouts, apart from financing the government policies. This reduces the earning for PSBs, and increases the non-performing assets.

(e) At present the government appoints the CMD, CEO, and Board members, based on the whims and fancies of the political party in power. This is, at least to some extent, has been responsible for scams and inefficiency in PSBs. This situation can be improved if the government's shareholding is reduced to below 50%.

However, the following are the counter arguments-

(a) The Nayak committee's case for privatization rests on flawed presumption of superior efficiency of private sector banks, because it is based on a comparison of performance of PSBs and private sector banks at a time when PSBs are weighed down by the problems of the economy at large.

(b) Such comparisons are flawed also by what is called 'survivor bias' in the private sector group. Several new private sector banks licensed after 1994 have ceased to exist. Precisely for this reason, they would not be found in the private bank group used for comparison. This lends an upward bias to the performance indicators of private banks.

(c) The comparisons ignore the scope of activities of PSBs and private banks. PSBs have an important development role. They took upon themselves the task of funding the investment in infrastructure which was an important driver of growth in the boom period of 2004-08. Private Banks can be

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choosier about what they wish to fund. If PSBs were to adopt such a narrow focus, sectors that are crucial to the economy would be starved of credit.

(d) The committee's faith in the functioning of private bank boards is truly touching, because it fails to note that boards in the private sector were absolutely ineffective in averting or reducing the impact of the financial crisis of 2007.

(e) The committee fails to understand the basic rationale for government ownership in banking sector. There is more to it than the larger social purpose of banking. Our experience has been that government ownership has been a factor underpinning stability in banking.

Experience has shown that it is possible to retain the public sector as the sheet anchor of the banking system without compromising on efficiency. Therefore, the report, though well-intentioned, needs a great deal of deliberation. The merits of government shareholding cannot be denied. But what should the extent of control be?

9.3 Nachiket Mor Committee

The Committee on Comprehensive Financial Services for Small Business and Low Income Households, under the Chairmanship of Dr. Nachiket Mor, was set up by the RBI in September 2013. The RBI appointed the Committee to propose measures for achieving financial inclusion and increased access to financial services. The following were the main recommendations of the committee-

(a) **A Universal Electronic Bank Account by January 1, 2016:** Since, bank account is an essential gateway to all financial services, even those outside RBI regulation. For example, IRDA has ordered the life insurance companies to give money only through cheque/electronic transfer to bank account of beneficiary. So if one doesn't have a bank account, he/she will be shut out of the entire financial system. Government also wants everyone to have bank accounts so that the money/subsidies can be directly transferred into beneficiary's account under DBT.

Therefore, the committee recommended that by January 1, 2016, every Indian resident (above 18) will be given a Universal Electronic Bank Account (UEBA). When the Aadhar Card is issued to any adult (above 18), he would be given a choice to automatically open a bank account. It'll be called Universal Electronic Bank Account (UEBA). This UEBA account would remain active as a perpetual account as long as the Aadhaar number remains active.

Criticisms of this recommendation:

- The idea of "Electronic" Bank account is futile, given that in many rural and Naxal areas, we don't have even the physical structure (office/staff), or even virtual structure (by mobile/broadband) to run banking services.
- Besides, if deadline is Jan 1st, 2016, means everything has to be finished by the end Dec 31st, 2015, which is very difficult to reach. A more plausible target is 100% bank accounts by 1st January 2018.
- Nachiket says bank account for every "resident" (not citizen). So even outsiders like Bangladeshi and Nepali immigrants get the benefit, and money comes out of tax payer's pocket. (How? Because even if SBI agrees to open UEBA accounts for free, it'll need to spend money on paper-work and staff. And over the years, SBI is not making optimum profits and suffering from large NPAs.)

(b) **Wide-spread payment network and universal access to savings:** The Committee proposed the setting up of Payments Banks whose primary purpose will be to provide payments services and deposit products to small businesses and low income households. It further proposed the setting up of Wholesale Banks which will lend to corporates and purchase 9ecuritized retail and small-business loans. These banks will only accept deposits larger than Rs 5 crore and will require minimum entry capital of Rs 50 crore.

However, the payment banks are not allowed to lend and must have a cap of Rs 1 lakh on deposits which can be invested in government securities, but they will have access to the RBI's liquidity windows. They will be required to invest at least 75 per cent of their 'demand deposit balances' in statutory liquidity ratio (SLR)-eligible government securities and treasury bills with maturity of up to one year. They can hold a maximum of 25 per cent in current and time/fixed deposits with other scheduled commercial banks for operational purposes and liquidity management. Payment banks will be allowed to issue debit cards, but not credit cards, and can offer current and savings account deposits.

These stipulations may serve to be a roadblock in the utilization of the potential of these banks, because they would be rendered unviable, as they can't earn revenue by way of interest on lending credit. This would also mean that the goal of financial inclusion, which includes access to credit at affordable cost, would not be served.

(c) **Sufficient access to affordable formal credit:** The Committee recommended a number of steps to be taken to help banks manage their credit exposures effectively, including allowing banks to purchase portfolio insurance.

The Committee proposed that a State Finance Regulatory Commission be set up into which all state level financial regulators will be merged. It recommended that the Non-Performing Asset reporting provisions and other regulations for Non-Banking Finance Companies (NBFCs) be aligned with those of banks.

It also suggested measures to ease funding constraints of NBFCs including relaxation of External Commercial Borrowings and equity investment rules. Further, it proposed the removal of barriers to the transition of NBFCs into banks by including more sectors in the Priority Sector Lending (PSL) classification.

(d) **Priority Sector Lending (PSL):** The Committee suggested that investment by banks in bonds and equities and provision of guarantees to PSL beneficiaries be counted towards meeting the banks' PSL targets. It recommended the removal of the cap on interest rate on loans at the base rate plus 8% per annum. It also recommended that the PSL target be revised from 40% to 50% of credit provided.

(e) **Customer protection issues:** The Committee proposed that financial service providers be required to commit capital against customer protection risk. It proposed that firms be made liable to ensure suitability of products issued to customers and that RBI frame regulations regarding the same. It proposed the setting up of a unified Financial Redress Agency (FRA) that will handle customer grievances across all financial products in coordination with their respective regulators.

(f) **Gradual removal of Statutory Liquidity Ratio (SLR) requirement:** Banks have to keep aside some assets into "liquid" form. These assets are called "liquid", because you can easily sell them and recover money in 'cash' form. When customers make such "bank runs", bank can sell away the SLR securities and quickly arrange cash for customers. So, in a way SLR is one type of emergency backup.

But SLR securities are very safe, low risk securities, but at the same time they provide very less revenue. Banks hardly earn 8% interest/dividend on such investment. So, most bankers consider the SLR investment as dead investment.

However, the experience of financial crisis of 2008 suggests that such requirements can be useful.

10 Pradhan Mantri Jan Dhan Yojana

Some of the recommendations of these committees have been implemented. However, the penetration of banking services is still less than optimal. In the light of this fact, the Prime Minister launched the Pradhan Mantri Jan Dhan Yojana.

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The scheme has been started with a target to provide 'universal access to banking facilities' starting with "Basic Banking Accounts". In next phase, micro insurance and pension etc. will also be added. In more specific terms the following are provisions under the scheme:

I. Account holders will be provided zero-balance bank account with RuPay debit card, in addition to accidental insurance cover of Rs 1 lakh.
II. After Six months of opening of the bank account, holders can avail 5,000 ⍰ overdrafts from the bank.
III. With the introduction of new technology introduced by National Payments Corporation of India (NPCI), a person can transfer funds, check balance through a normal phone which was earlier limited only to smart phones so far.
IV. Mobile banking for the poor would be available through National Unified USSD Platform (NUUP) for which all banks and mobile companies have come together.

Since the establishment and penetration of banking system is a time taking process, therefore there has been a focus on extending the micro-credit to the unreached segments and regions. The following section deals with the details of micro-credit movement in India.

11 Micro-credit Movement for Financial Inclusion

Microcredit programmes extend small loans to very poor people for self-employment projects that generate income, allowing them to care for themselves and their families. In other words, Microcredit is the extension of very small loans (microloans) to impoverished borrowers who typically lack collateral, steady employment and a verifiable credit history. It is designed not only to support entrepreneurship and alleviate poverty, but also in many cases to empower women and uplift entire communities by extension.

Modern microcredit is generally considered to have originated with the Grameen Bank founded in Bangladesh by Nobel laureate Muhammad Yunus in 1983. Many traditional banks subsequently introduced microcredit despite initial misgivings. As of 2012, microcredit is widely used in developing countries and is presented as having "enormous potential as a tool for poverty alleviation."

After Mohammed Yunus received a Nobel Prize for his work on micro credit, most would agree that this is probably the only way to bring about financial inclusion of the small and marginal farmers. In India too, budget after budget has announced schemes to this end: from incentivizing self-help groups (SHGs) to opening bank accounts for beneficiaries of the National Rural Employment Guarantee (NREG) scheme, to crop insurance, etc. Yet, none of these seem to work effectively and cases of farmer suicides do still crop up in various parts of the country.

What is the difference between microfinance and microcredit?

Although often used interchangeably, microfinance and microcredit are in fact quite distinct. Microfinance is a much broader concept than microcredit and refers to loans, savings, insurance, money transfers, and other financial products targeted at poor and low-income people. Microcredit refers more specifically to making small loans available to poor people, especially those traditionally excluded from financial services, through programmes designed specifically to meet their particular needs and circumstances.

The micro-credit movement in India

In the case of India, the banking sector witnessed large scale branch expansion after the nationalization of banks in 1969, which facilitated a shift in focus of banking from class banking to mass banking. It was, however, realized that, notwithstanding the wide spread of formal financial institutions, these institutions were not able to cater completely to the small and frequent credit needs of most of the poor. This led to a search for alternative policies and reforms for reaching out to the poor to satisfy their credit needs.

The beginning of the micro finance movement in India could be traced to the self-help group (SHG) - bank linkage programme (SBLP) started as a pilot project in 1992 by National Bank for Agricultural and Rural Development (NABARD). This programme not only proved to be very successful, but has also emerged as the most popular model of micro finance in India. Other approaches like micro finance institutions (MFIs) also emerged subsequently in the country.

At present, there are two main models of micro finance delivery in India: the SBLP model and the MFI model. The SBLP model has emerged as the dominant model in terms of number of borrowers and loans outstanding. In terms of coverage, this model is considered to be the largest micro finance programme in the world. These two models are discussed as under-

A. **Self-Help Group (SHG) - Bank Linkage Programme (SBLP):** The pilot project was launched by NABARD with the following objectives:

   I. To evolve supplementary credit strategies for meeting the credit needs of the poor by combining the flexibility, sensitivity and responsiveness of the informal credit system with the strength of technical and administrative capabilities and financial resources of the formal credit institutions;

   II. To build mutual trust and confidence between the bankers and the rural poor; and

   III. To encourage banking activity, both on the thrift as well as on credit sides, in a segment of the population that the formal financial institutions usually find difficult to cover.

   The SHGs were expected to facilitate collective decision making by the poor and provide 'doorstep banking', the banks as wholesalers of credit, were to provide the resources, while the NGOs were to act as agencies to organize the poor, build their capacities and facilitate the process of empowering them. It was expected that the pilot project would prove advantageous to both banks as well as the SHGs. The banks would gain by a way of reduction in their transaction costs due to reduction in work relating to appraisal, supervision and monitoring of loans. The SHGs would benefit by getting access to a larger quantum of resources, as compared to their meager corpus generated through thrift. The banks were expected to provide credit in bulk to the group and the group, in turn, would undertake on-lending to the members.

   The programme has since come a long way from the pilot project of financing SHGs across the country. It has proved its efficacy as a mainstream programme for banking with the poor, who mainly comprise the marginal farmers, landless laborers, artisans and craftsmen and others engaged in small businesses in the rural areas. The main advantages of the programme are timely repayment of loans to banks, reduction in transaction costs both to the poor and the banks, doorstep "saving and credit" facility for the poor and exploitation of the untapped business potential of the rural areas. The programme, which started as an outreach programme has not only aimed at promoting thrift and credit, but also contributed immensely towards the empowerment of the rural women.

B. **Micro Finance Institution (MFI) Approach:** While the SBLP model remains the most widely used model of micro finance in India, the MFI model has also gained momentum in the recent past. The MFI model in India is characterized by a diversity of institutional and legal forms. MFIs in India exist in a variety of forms, like trusts registered under the Indian Trust Act; societies registered under the Societies Registration Act, 1860; Co-operatives registered under the Mutually Aided Cooperative Societies Acts of the States; and non-banking financial companies (NBFC)-MFIs, which are registered under Section 25 of the Companies Act, 1956 or NBFCs registered with the Reserve Bank. These MFIs are scattered across the country and due to the multiplicity of registering authorities, there is no reliable estimate of the number of MFIs. The most frequently used estimate is that their number is likely to be around 800.

Policy initiatives for microfinance in India

Several initiatives have been taken by the Reserve Bank, NABARD and also SIDBI with a view to giving a further fillip to the micro finance movement in India. A summary of major initiatives is presented as under-

(a) **Policy Initiatives by the Reserve Bank of India (RBI):** In January 1993, SHGs, registered or unregistered were allowed by the Reserve Bank to open savings bank account with banks. Further, the RBI advised the banks, *inter alia*, that financing of SHGs should be included by them as part of their lending to the weaker sections.

   Recognizing the growing importance of micro finance, the Reserve Bank constituted a micro credit special cell in the Bank in 1999 to suggest measures for mainstreaming micro credit and accelerating flow of credit to MFIs. The special cell has since been converted into a micro finance and financial inclusion division in the Reserve Bank.

Based on the reports of the special cell constituted in the Reserve Bank and the Task Force on Supportive Policy and Regulatory Framework, the Reserve Bank issued comprehensive guidelines to banks in February 2000 for mainstreaming micro credit and enhancing the outreach of micro credit providers. These guidelines, *inter alia*, stipulated that micro credit extended by banks to individual borrowers directly, or through any intermediary, would from then onwards be reckoned as part of their priority sector lending.

(b) **Recent Initiatives by NABARD:** NABARD has been playing a crucial developmental role for the micro finance sector in India. NABARD has been organizing/sponsoring training programmes and exposure visits for the benefit of bank officials, NGOs, SHGs and Government agencies to enhance their effectiveness in the field of micro finance. The best practices and innovations with respect to the sector are widely circulated among Government agencies, banks and NGOs. NABARD also provides support for capacity building, exposure and awareness building of the SHGs and NGOs.

NABARD launched the 'Micro-Enterprise Development Programme' (MEDP) for skill development in March 2006. The basic objective was to enhance the capacities of matured SHGs to take up micro enterprises through appropriate skill upgradation. The programme envisaged development of enterprise management skills in existing or new livelihood activities, both in farm and non-farm sectors.

NABARD also provides marketing support to the SHGs for exhibiting their products. In addition, NABARD also provides promotional grant support to NGOs, RRBs, farmer's clubs and individual volunteers and assists in developing capacity building of various partner agencies. NABARD has been making efforts to increase the number of partner institutions as self-help promoting institutions (SHPIs).

Recognizing the role played by MFIs, in extending micro finance services in the unbanked areas, NABARD extends support to these institutions through grant and loan based assistance. NABARD has been selectively supporting MFIs for experimenting with various micro finance models such as replication of Grameen Model, NGO networking (bigger NGOs supporting smaller NGOs), credit unions and SHGs federations, among others, to meet credit requirements of the unreached poor. NABARD provides loan funds in the form of revolving fund assistance (RFA) on a selective basis to MFIs to be used by them for on-lending to SHGs or individuals.

(c) **Micro Finance Initiatives by SIDBI**: SIDBI launched its micro finance programme in February 1994 on a pilot basis. The programme provided small doses of credit funds to the NGOs all across the country. NGOs acted as financial intermediaries and on-lent funds to their clients. Limited amount of capacity building grant was also provided to the NGOs.

With a view to reducing the procedural bottlenecks, expanding the outreach, meeting the huge unmet demand of the sector and striving towards its formalization, SIDBI reoriented its policy and approach to create a sustainable micro finance model that would significantly increase the flow of credit to the sector.

SIDBI was one of the first institutions that identified and recognised NGO/MFI route as an effective delivery channel for reaching financial services to those segments of the population not reached by the formal banking network. As a result of bulk lending funds provided, coupled with intensive capacity building support to the entire micro finance sector, it has come to occupy a significant position in the Indian micro finance sector. Today, SIDBI is one of the largest providers of micro finance through the MFIs.

SIDBI introduced a product called 'transformation loan' in 2003 to enable the MFIs to transform themselves from an informal set up to more formal entities. This loan is a quasi-equity product with longer repayment period and features for conversion into equity at a later date, when the MFI decides to convert itself into a corporate entity. Consequently, a number of MFIs went ahead with the transformation and some of them have now grown significantly and are serving millions of clients across several states.

11.1 Does Microcredit Really Help Poor People?

The impact of microcredit is a subject of much controversy. Proponents state that it reduces poverty through higher employment and higher incomes. This is expected to lead to improved nutrition and improved education of the borrowers' children. Some argue that microcredit empowers women. In Indian context the SHG-Bank Linkage Program has been a game changer in inculcating the thrift and saving behavior, which in turn has resulted in creation of income generating assets. The available evidence indicates that in many cases microcredit has facilitated the creation and the growth of businesses.

The usual story line has been that it is a tool of extraordinary power to lift poor people—especially women—out of poverty, by funding their microenterprises and raising their incomes. This picture has been buttressed by hundreds of inspiring stories of micro entrepreneurs who used tiny loans to start or expand their businesses, and experienced remarkable gains not only in income and consumption but also in health, education, and social empowerment.

However, critics say that microcredit has not increased incomes, but has driven poor households into a debt trap, in some cases even leading to suicide. They add that the money from loans is often used for durable consumer goods or consumption instead of being used for productive investments, that it fails to empower women, and that it has not improved health or education.

11.2 Microcredit no panacea for poverty: study

Conducted by researchers affiliated to Innovations for Poverty Action (IPA) and The Abdul Latif Jameel Poverty Action Lab (J-PAL) at MIT, the studies have shown no evidence of microcredit successfully alleviating poverty. Microcredit also had no impact on women's empowerment, the findings showed, upturning one of the articles of faith of development policy, including in India.

A case study: Micro-credit has been a disaster for the poorest in South Africa: The micro-credit medicine applied to post-apartheid South Africa has turned out to be a deadly one. It is now increasingly clear that the much-lauded market-driven microcredit model has inflicted untold damage on the South African economy and society.

The microcredit-induced problems that emerged in South Africa are two-fold. First, microcredit per se is actually an "anti-developmental" intervention. For one thing, it exists on paper to support the smallest income-generating activities, but in practice is increasingly all about supporting consumption spending. In South Africa, the microcredit movement has created an incredibly risky and expensive way to support the immediate consumption needs of the very poorest.

Perhaps most importantly, the growing dominance of the microcredit model has meant that South Africa's scarce financial resources have essentially been diverted away from more productive and sustainable business activities; notably away from formal manufacturing-led SME development, which the country desperately needs. Microcredit institutions that successfully mobilise savings, remittances and public and private investment funding, and then profitably channel this largesse into microcredit applications, effectively de-fund the very enterprise sectors most closely associated with sustainable local economic development and poverty reduction.

A further intractable problem with microcredit in South Africa is related to the extensive commercialization that was introduced into the global microcredit industry in order to make it financially self-sustaining. Far too many high-profile microcredit supporters and policymakers naively bought into the myth of the free market, including its particular aversion towards robust regulation. There was hope that for-profit microcredit institutions would dutifully stick to their allotted mission and responsibly lend to the poor. However, just as in the wider economy, where the actions of the financial institutions on Wall Street brought on a global recession, the widely-held assumption that private banks and microcredit institutions would be responsible also proved to be spectacularly wrong.

Bombarded with microloans in such a way that today they simply cannot repay even a fraction of what they owe (estimates are that 40% of the South African workforce's income is spent on repaying debt), South Africa's poor are now caught in a micro debt-trap of unimaginable proportions.

Micro-credit is one of the factors: The micro-credit has often generated self-employment, but it has not necessarily increased incomes after interest payments. In some cases it has driven borrowers into debt traps. There is no evidence that microcredit has empowered women. Thus, microcredit has achieved much less than what its proponents said it would achieve, but its negative impacts have not been as drastic as some critics have argued. Microcredit is just one factor influencing the success of a small businesses, whose success is influenced to a much larger extent by how much an economy or a particular market grows.

12 Controversies/Challenges

Financial inclusion in India is often closely connected to the aggressive micro credit policies that were introduced without the appropriate regulations oversight or consumer education policies. The result was consumers becoming quickly over-indebted to the point of committing suicide, the lending institutions saw repayment rates collapse after politicians in one of the country's largest states called on borrowers to stop paying back their loans, threatening the existence of the entire 4 billion a year Indian microcredit industry. This crisis has often been compared to the mortgage lending crisis in the US.

The challenge for those working in the financial inclusion field has been to separate micro-credit as only one aspect of the larger financial inclusion efforts and use the Indian crisis as an example of the importance of having the appropriate regulatory and educational policy framework in place.

The difficulty of micro-lending is in scaling it up. Successful micro-lending operations, although largely self-sustaining, cannot grow out of retained earnings, nor can they raise capital in financial markets. To turn micro-lending into a big factor in economic and political progress, it must be scaled up significantly. This would require general support for the industry as well as capital for individual ventures.

Although the growth of SHGs in India has been phenomenal there are some significant problems faced by them which might hamper their growth in the coming years. For instance politicizing of subsidy allotment among SHGs has become a big problem. Qualification for government subsidy is easily influenced by Panchayat members. Thus, Panchayats are now competing with NGOs and rural banks in forming SHGs. While the Panchayat-formed SHGs have the lure of government grants they are often open to political pressure and misuse of funds by the recommending Panchayats and/or political parties.

Thus the qualities of NGO-formed groups are usually superior to those formed by the local government (Panchayats) and villagers are often keen to join the former. These age-old problems of government initiatives in poverty reduction, unless stemmed quickly, can actually harm the movement by eroding the fundamental precepts of self-help and empowerment of the poor.

The main challenges facing the SHG - Bank linkage model are:

- The pace of expansion of the programme.
- The limited number of NGOs in regions where the programme has not picked up
- The cost of promotion of NGO being high.
- The per capita credit outlays are small and not commensurate with the costs involved in.
- Bringing the SHGs to the banking main stream.
- Overloading of SHG with multiple agenda, particularly Government sponsored programmes.

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13 Possible way forward

RBI and Government as part of their development role, NABARD, which is spearheading this programme, and banks who are the main promoters of the program, may initiate the following effective steps to overcome these shortcomings:

- **Promotion of Federation structure:** The long term sustainability of the SHG model may require a federal structure, without severing the linkages that the SHGs have with the local bank branches. The assumption that the federation structure should not be supplanted on the SHGs and can be addressed when the demand emerges needs reconsideration.
- **Maintenance of National Database on SHGs and MFIs:** At present, NABARD is maintaining the database on SHGs. It publishes annual hand book on microfinance in India with focus only on SHG Bank linkage programme. It is suggested that NABARD be assigned the responsibility of collection of data involving the entire sector, their compilation and dissemination.
- **Comprehensive regulatory framework:** Presently, there is no distinctive regulatory framework for the MFIs in India. Therefore, there is a need of an exclusive regulation to regulate MFIs in India.
- **Contribution to the MFDEF (Micro Finance Development and Equity Fund) by Banks:** The corpus may be built up on an ongoing basis. A portion of profits of the bank may be contributed to the fund. The Government may provide tax relief to Banks for the contributions made.
- **An integrated package of services ('a credit-plus' approach) rather than just providing credits**: When access to credit is combined with savings facilities, non-productive loan facilities, insurance, enterprise development and welfare-related services, the adverse effects discussed above can be diminished.
- **Role of Corporate in Micro Finance:** Corporate India, of late, shown keen interest in the SHG movement as it provides an alternative business opportunity for them besides being a means to actualize its corporate social responsibility objectives. Many corporates have realized that the people at the bottom of pyramid can be brought into their business model. The group also sees a critical role of the corporate sector in providing market linkage to the products of the rural areas on a sustainable basis. The following are the examples.
  - ITC (through e-choupal model).
  - Hindustan Lever Ltd (through Stree sakti project).
  - Mahindra & Mahindra (through Mahindra Subh labh).
  - Tata Group (through Tata kisan sansar)

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