

## FINANCIAL INCLUSION IN INDIA: NEED FOR INSTITUTIONAL CHANGES

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It gives me great pleasure to be here in your midst this evening and to deliver the Seventh Bharat Ratna Rajiv Gandhi Memorial Lecture. I am grateful to the Academy of Grassroots Studies and Research of India for their decision to confer on me the Bharat Ratna Rajiv Gandhi Outstanding Leadership Award for the year 2008. I accept the Award in all humility. I am also grateful to His Excellency, the Governor of Andhra Pradesh, Shri Narayan Datt Tiwari, for his kind presence this evening.

Rajiv Gandhi will go down in history for two reasons: First, he gave a new orientation to politics in our country. He recognised the importance of technology and gave to technology development a major thrust. The various technology missions that he initiated have brought about significant changes in the Indian economy. Second, he gave Constitutional recognition to the third-tier of government in our country. The village panchayats and municipalities acquired a new status because of the Constitutional amendments introduced by him. Let us hope that his dream of making local self-governments the real levers of progress becomes a reality.

I propose to speak to you today on financial inclusion and the role that the various institutions which provide micro finance can play in bringing about greater inclusion.

### Nature of Inclusion

Financial inclusion denotes delivery of credit and other financial services at an affordable cost to the vast sections of the disadvantaged and low-income groups. The various financial services include savings, credit, insurance and payments and remittance facilities. It will be wrong to classify all those who are not borrowing from the organized financial system as excluded. What is relevant is that those who want credit should not be denied the same provided they are bankable. The criterion of being bankable should not be interpreted narrowly to exclude the vast majority. The objective of financial inclusion is to extend the scope of activities of the organized financial system to include within its ambit people with low incomes. Through graduated credit, attempts must be to lift the poor from one level to another so that they come out of poverty. Financial inclusion may, therefore, be defined as a process of enabling access to timely and adequate credit and other financial services by vulnerable groups such as weaker sections and low-income groups at an affordable cost.

- Text of the **Seventh Bharat Ratna Rajiv Gandhi Memorial Lecture** delivered by **Dr. C. Rangarajan**, the then Chairman, Economic Advisory Council to Prime Minister of India, on 20<sup>th</sup> August, 2008 at Hotel Bliss (Darbar Hall), Tirupati, Andhra Pradesh, under the aegis of Academy of Grassroots Studies and Research of India (AGRASRI), in Collaboration with Rajiv Rural Development Foundation (RRDF), Tirupati (Andhra Pradesh).

## **Extent of Exclusion**

NSSO data reveal that 45.9 million farmer households in the country (51.4%), out of a total of 89.3 million households do not access credit, either from institutional or non-institutional sources. Further, despite the vast network of bank branches, only 27% of total farm households are indebted to formal sources (of which one-third also borrow from informal sources). Farm households not accessing credit from formal sources as a proportion to total farm households is especially high at 95.91%, 81.26% and 77.59% in the North Eastern, Eastern and Central Regions respectively. Thus, apart from the fact that exclusion in general is large, it also varies widely across regions, social groups and asset holdings. The poorer the group, the greater is the exclusion.

## **Institutional Changes**

The question that is before us is how to extend the scope of activities of the organized financial system to include low income groups. The institutions which currently provide financial services in the rural areas include branches of commercial banks, regional rural banks, cooperative societies and micro-finance institutions. What is required now is not creating new institutions for extending their out-reach but finding ways and means to effect improvements within the existing formal credit delivery mechanism and evolve new models for extending out-reach. In a broad sense, we need to address issues on the supply side as well as demand side. The formal banking system, the rural cooperatives and non-governmental organizations must be strengthened organizationally to extend their out-reach. The financially excluded sections require products which are customized to meet their needs. Financial exclusion is also caused by demand side issues. Unless steps are taken on the demand side, that is in the “real sectors”, mere supply side solutions from the financial sector will not work. Credit is necessary for this, but not sufficient. Credit has to be an integral part of an overall programme aimed at improving the productivity and income of small farmers and other poor households. Putting in place an appropriate credit delivery system to meet the needs of marginal and sub-marginal farmers must go hand in hand with efforts to improve the productivity of such farm households.

Let me place before you some thoughts on strengthening the credit delivery system in rural areas of commercial banks, Regional Rural banks and micro finance institutions.

## **Commercial Banks**

The commercial banks have a large outreach. There are, at present, 33,500 commercial bank branches in rural and semi-urban centers in the country. The critical question is how to make these rural branches more effective in terms of delivering credit to the small and the very small borrowers. I list below some approaches in this regard.

First, a critical factor required for providing credit to marginal and sub-marginal farmers as well as other small borrowers is the empathy of the bank officers. Rural lending requires a specific type of organizational ethos, culture and attitude. Rural branches of banks have to be farmer-friendly. Lending to the low-income groups needs motivated bank staff. Such motivation

is a function of attitude and beliefs as well as a system of incentives. The possibility of creating a separate cadre of rural bank employees does not appear to be feasible. Several studies have shown that there is a positive co-relation between the extent of training undergone by the managers and their overall attitude. More needs to be done in this regard.

Second, rural branches must go beyond providing credit and extend a helping hand in terms of advice on a wide variety of matters relating to agriculture and other allied activities. We may have to think in terms of branches on the lines of agricultural development branches of SBI where advice on farm and non-farm issues were provided by technical staff attached to the branches. As the Committee on Financial Inclusion has suggested, at least, one branch of the lead bank at the block or taluka level can be designated as a nodal branch to address the issue of exclusion. These branches must be strengthened with technical staff for provision of developmental services in the farm and non-farm sectors. All banks could make use of the advice provided by such branches.

Third, in districts where the population per branch is much higher than the national average, commercial banks may be encouraged to open branches. 139 districts in 15 states have been identified by Reserve Bank as inadequately served by the banking system.

Fourth, there is need for the simplification of the procedures in relation to granting of loans to small borrowers. In some cases, enabling legislations have to be passed. Stamp duty exemption for loan documents relating to small borrowings is also needed. On the whole, a simplified document for the grant of small loans must be evolved. Some steps have already been taken in this regard by NABARD.

Fifth, the SHG bank linkage scheme has proved to be an effective way of providing credit to very small borrowers. This needs to be further strengthened. The SHG-bank linkage programme has worked well and has contributed significantly to financial inclusion. The cumulative number of groups financed by the banking system is close to 2.3 million. The financial inclusion attained through SHGs is sustainable and scalable on account of its various positive features. One of the distinctive features of the SHG-bank linkage programme has been the high recovery rate. However, the spread of SHGs is very uneven and is more concentrated in southern states. This regional imbalance needs to be corrected and special efforts in this regard may have to be taken by NABARD. SHGs also need to graduate from mere providers of credit for non-productive purposes to promoting micro enterprises. Several state governments have been very active in the promotion of SHGs.

However, there is no need to provide any interest rate subsidy to SHGs. Banks do provide them credit at reasonable rates of interest. The financial support of the state governments could be better directed towards building appropriate capacities in the self-help groups and providing technology support and marketing facilities. There are other quality issues which have arisen in the wake of the sharp quantitative expansion. These need to be addressed. Federations of SHGs at village and taluka levels have certain advantages. However, the disadvantage is that banks may

lose their direct contact with SHGs, if federations act as intermediaries between the financing banks and SHGs. Perhaps, the best course of action would be to make the federations act as facilitators rather than as financial intermediaries. Federations, if they emerge voluntarily from amongst SHGs, must be encouraged.

Sixth, even though SHG-bank linkage has emerged as an effective credit delivery channel to the poor clients, there are segments within the poor who are left out such as share croppers/oral lessees/tenant farmers, whose loan requirements are much larger but who have no collaterals to fit into the traditional financing approaches of the banking system. To service such clients, Joint Liability Groups (JLGs), an up-gradation of SHG model, could be an effective way. The Committee on Financial Inclusion had recommended that the adoption of the JLGs concept could be another effective method for purveying credit to small farmers, marginal farmers, tenant farmers, etc. and thereby reduce their dependence on informal sources of credit.

Finally, the business facilitator and correspondent model needs to be effectively implemented. In order to increase the outreach of the banking sector, the Reserve Bank have permitted banks to use the services of specified institutions as intermediaries for providing banking services. However, this scheme has not taken off. This model has a high potential. Banks must take the initiative to remove the obstacles that come in the way of an extended use of facilitators and correspondents. Rules, at present, permit not only institutions but also certain category of individuals to function as business facilitators. This list can be further expanded to include such people as ex-service men as has been done recently. At present, individuals are not allowed to function as business correspondents. Perhaps, a relaxation can be made here. I believe this has also been done recently by RBI. Individuals who have served as bank facilitators and have shown to have a satisfactory record may also be used as business correspondents. In fact, the appointment of well-chosen individuals holds out the best promise in this regard. However, one critical issue in the effective use of this model revolves around as to who should bear the additional transaction costs resulting from the employment of facilitators and correspondents. There has to be some flexibility with respect to the charging of interest rate. These transaction costs can still be accommodated within the present stipulation that the interest rate charged should not exceed the PLR.

### **Regional Rural Banks**

Regional rural banks were originally conceived as low cost institutions having rural bias, local feel and pro-poor focus. The original assumption regarding the low cost nature of these institutions was belied. In fact, they soon turned into loss making institutions. With the changes introduced in the post-liberalization period, there is a remarkable turn around in the financial performance of the RRBs. RRBs are yet another instrument to achieve the goal of financial inclusion. At present, RRBs have close to 15000 branches in rural areas. The share of RRBs in the loan account of all scheduled commercial banks in rural areas is an impressive 37 per cent. However, they account for only 21 per cent of the total credit outstanding in rural areas implying

thereby that the clientele comprises of small borrowers. RRBs have done well also in relation to the promotion of SHGs. Of the total 22.4 lakh SHGs credit linked by the banking industry, 33 per cent linkage is done by RRBs. Strengthening of the RRBs could be one major policy intervention for promoting greater financial inclusion. The operations of RRBs could be expanded to 80 hitherto uncovered districts. I understand action is already being taken in this regard. RRBs may also usefully adopt the business facilitator and business correspondent model to achieve greater inclusion.

### **Role of Technology**

In the task of making banking services available to everyone, technology has an important role to play. The required outreach into interiors with low operational costs is only possible with the use of appropriate technology. Technology has to be leveraged to create channels beyond branch network to reach the unbanked and to extend to them banking services similar to those dispensed from branches. In short, technology has to enable the branch to go to the customer instead of the other way round. The RBI has set up an Advisory Group for IT enabled financial inclusion to facilitate development of information technology solutions for delivery of banking services. It is understood that the Group will prescribe certain minimum parameters and standards that are essential for setting up robust technology solutions. The essential ingredients of all the models under consideration include:

- a. the issue of a smart card to the client in the village on which all the transactions are recorded;
- b. a hand-held terminal with the business correspondent at the village level; and
- c. a Central Processor Unit (CPU) linking the smart cards and BC terminals with the banks.

It is necessary to ensure that every transaction made is accompanied by a print out being provided to the farmers or other clients. The operating costs of these models are expected to be minimal and can be easily absorbed by banks. As the transaction increases in volume it will become easier to absorb the incremental operating costs. More importantly, the costs of the technology solutions will be substantially lowered if the infrastructure is shared. The Report of the Committee on Financial Inclusion has recommended the setting up of a Technology Development Fund. The Central Budget has also made a provision for this. This fund can be utilised to strengthen the technology base for financial inclusion.

### **Micro Financial Institutions**

Micro finance institutions play a significant role in ensuring financial inclusion. There are several legal forms of micro finance institutions (MFIs). There are about 1000 NGO-MFIs, 3000 cooperative MFIs and about 20 company MFIs. However, the company MFIs are the major players accounting for over 80 per cent of the micro finance loan portfolio. Ten such MFIs are reported to have an outreach of 100000 micro finance clients. However, an overwhelming majority of MFIs are operating on a smaller scale with clients ranging between 500 to 1500 per MFI. The geographical distribution of MFIs is skewed with concentration in southern India where the rural

branch network of banks is also strong. It is estimated that MFIs added during the year 2006-07 3 million new borrowers and this takes the total coverage to 10.5 million borrowers

With respect to the operations of MFIs, a number of issues have arisen in the recent period. One such issue relates to the rate of interest. It is recognised that the transaction costs for delivering credit to very small borrowers are high. Also to the extent to which various advisory services are provided, the cost further goes up. It is necessary for MFIs to separate the pure interest costs from other costs which are charged to the borrowers because of the additional services provided. Overall it is necessary to ensure that the burden on the borrower is not such as to make him default. MFIs need to ensure that the earnings capacity of the borrowers is sufficiently enhanced enabling them to bear the cost of borrowing. Taking a holistic view, it is necessary for micro finance institutions to keep the overall cost to the borrowers maintained at a level that is consistent with the repaying capacity of the borrowers.

As the Committee on Financial Inclusion has recommended, there is a need to recognise a separate category of microfinance - non-banking finance companies (MF-NBFCs). This should be done without any relaxation on the start up capital. They should also be subject to all the regulatory prescriptions applicable to NBFCs. Such MF-NBFCs could be defined as NBFCs that provide credit up to a specified amount to the borrowers. Consistent with the definition of micro finance that is prescribed in the new bill, it may be specified that MF-NBFCs are those with 80 per cent of the assets in the form of microcredit of up to Rs.50,000 for agriculture, allied and non farm activities and in the case of housing, loans up to Rs. 1,50,000, per individual borrower, whether given through a group mechanism or directly. The supervision of MF-NBFCs could be delegated to NABARD by RBI. These MF-NBFCs could be recognised as business correspondents of banks for providing savings and remittance services. They will not, however, serve as correspondents on the lending side as there could be a conflict of interest.

For the micro finance movement to gather momentum, it is necessary that all the various legal forms of micro finance institutions should be encouraged. Each legal form has its own special advantages. However, it needs to be noted even the most successful micro finance institutions in the corporate sector depend to a large extent on funding by the banks. Thus, the banks will continue to play a key role either directly or indirectly in micro finance.

### **National Rural Financial Inclusion Plan**

The Committee on Financial Inclusion has recommended that a National Rural Financial Inclusion Plan may be launched with a clear target to provide access to comprehensive financial services, including credit, to at least 50% of financially excluded households, say 55.77 million by 2012 through rural/semi-urban branches of Commercial Banks and Regional Rural Banks. The remaining households, with such shifts as may occur in the rural/urban population, have to be covered by 2015. Semi-urban and rural branches of commercial banks and RRBs may set for themselves a minimum target of covering 250 new cultivator and non-cultivator households per branch per annum, with an emphasis on financing marginal farmers and poor non-cultivator households. This is an achievable target.

Looking at the picture as a whole, two initiatives that will bring about a significant surge forward of the micro finance sector will be the growth of the bank-SHG linkage programme and the induction of individuals as business correspondents. The two will constitute the main pillars of the future development of bank related micro finance, even as other forms of micro finance institutions will continue to grow. The goal of making a significant progress towards financial inclusion seems attainable. Financial inclusion is no longer an option but a compulsion.



**Padma Vibhushan Dr. C. Rangarajan**, the then Chairman of the Economic Advisory Council to the Prime Minister of India, delivering the **Seventh Bharat Ratna Rajiv Gandhi Memorial Lecture** on 20 August, 2008 at Hotel Bliss (Darbar Hall), Tirupati, under the aegis of AGRASRI.