Financial Inclusion and Development: Issues and Concerns

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Abstract

In India, growth with equity has been the central objective right from the inception of the planning process. Accordingly, over the years, initiatives have been taken continuously to address the issue of inclusive growth. The Eleventh Five Year Plan (2007-12) and Twelfth Five Year Plan (2012-17) re-emphasized the need for a more inclusive growth in order to ensure that the per capita income growth is more broad-based. India has followed a multi-pronged strategy to promote financial inclusion. The global experience also suggests that countries that allow diversity in approaches are more likely to achieve better results. Diversity in approaches not only serves better the diverse demand for financial services, but also reduces systemic risks, increases competition, and improves efficiency. The farming micro, small and medium enterprises have immense potential to play a critical role in achieving the objective of faster and more inclusive growth as these sectors contribute to output and employment generation in a significant way with capacity to expand regionally diversified production and generating widely dispersed off-farm employment.

Introduction

There is no universally accepted definition of financial inclusion. Financial inclusion is generally defined in terms of exclusion from the financial system. The raking or operational definitions of financial exclusion generally focus on ownership or access to particular financial products and services. The access to finance could be divided into four segments: 1.the proportion of the population that uses a bank or bank like institution, 2.the population which uses service from non–bank (other formal) financial institutions, but does not use bank services, 3.the population which only uses service providers, 4.percentage of population transacting regularly trough formal financial instruments and 5.the population which uses no financial services. Since measuring inclusion is perceived to be difficult, financial inclusion has generally been defined in terms of exclusion from the financial system. The working or operation al definitions of financial exclusion generally focus on ownership or access to particular financial products and services. Specific indicators such as number of bank's branches are generally used as measures of financial inclusion in an economy.

In India the financial excluded sections comprise largely marginal farmers, landless laborers, oral lessees, self-employed and un-organized sector enterprises, urban slum dwellers, migrants, ethnic minorities and socially excluded groups, senior citizens and women. Some of the important causes of relatively low extension of institutional credit in the rural areas are risk perception, cost of its assessment and management, lack of rural infrastructure, and vast geographical spread of the rural areas with more than half million villages, some sparsely populated. There is everything to be gained making the financial sector adopt more inclusive practices. Economic growth could possibly be at even higher rate if access to financial services and products becomes widespread. Financial inclusion, i.e. remedy of financial exclusion, is a process of making formal financial services accessible and affordable to all. Financial services do not mean the provision of credit alone, but provision of all other services, especially savings, insurance and remittance facilities.

Need of Financial Inclusion

The challenges of achieving more inclusive growth can be met by policies that encourage easier and affordable access to financial services. Recent data shows that countries with large proportion of population excluded from the formal financial system also show higher poverty ratios and higher inequality. Despite the impressive numbers, growth has failed to be sufficiently inclusive, particularly after the mid-1990s. Only 30% of the bank branches operate in the rural areas that house 72.2% of the country's population. Further, rural India accounts for just 9% of total deposits, 7% of total credit, 10% of the life- insurance and 0.6% of non-life business.

The India has been ranked poorly in the first-ever Index of Financial Inclusion(IFI) prepared by A New Delhi –based think-tank need come as surprise to the observers of the country's banking and financial scenario. The index prepared by the Indian Council for Research on International Economic Relations (ICRIER), to find out the reach of banking services in 100 countries world-wide, ranks India at 50th position below countries such as Kenya and Morocco. The study underlines the need for expansion of banking services to ensure that they reach the weaker sections. Financial inclusion is a key priority for India not only for sustaining the country's high growth trajectory but also for poverty alleviation at a much faster pace and for bridging the growth rural-urban divide. This cannot happen unless special efforts are made for deepening the market penetration of banking services to move from "class-banking" towards "mass-banking". There is therefore an urgent need to fast-track financial inclusion. The inclusive growth now considered essential even to sustain the growth momentum. The rationale behind inclusive growth is as under:

(1) The poor chunk of India's population is based in rural areas.

(2) From supply-side management, growth in agriculture is necessary in order to keep manufacturing prices under check provide food security and keep inflation under control.

(3) Higher growth in agriculture and rural areas coupled with demographic dividend (i.e. growing proportion of population in the working age group of 15-65) will lead to a rise in the savings level for financing the increasing level of investments necessary to sustain the overall growth momentum.

(4) The limitations on increasing production and productivity in agriculture are driving migration to urban areas leading to population pressure in urban areas and increase in urban poor.

(5) In India, the growth process is knowledge-based and services-led the requirement of skilled labour is quite substantial in comparison to the present availability. In order to ensure adequate supply of skilled labour force, huge social sector investment is required covering the vast majority of people who may not be able to afford such education and skill development.

(6)It is the unorganized non-farm sector that is increasingly absorbing most of the labour force.

This sector has huge potential for growth once there is sufficient investment in infrastructure ensuring linkage to market and easier access to assets and skills. Entrepreneurial development has to be encouraged by having an enabling competitive environment and easy availability of finance for newer projects and enterprises. In Prahlad's words: "if we stop thinking of the poor as victims or as a burden, and start recognizing them as resilient and creative entrepreneurs and value conscious consumers, a whole world of opportunity will open up."

Nature of the Financial Exclusion

The nature and forms of exclusion and the factors responsible for it are varied and, no single factor could explain the phenomenon. The principle barriers in the expansion of financial services are often identified as physical access, high charges and penalties, condition attached to product, which make them inappropriate or complicated and perceptions of financial services institutions which are thought to be unwelcoming to low income people. There has also been particular emphasis on socio-cultural factors that matter for an individual to access financial service.

Financial exclusion is a serious concern among the low-income households as well as small businesses, mainly located in semi-urban and rural areas. It is the unavailability of banking services to people living in poverty. According to K. C. Chakraborty "Financial Exclusion" is the lack of access by certain consumers to appropriate, low cost, fair and safe financial products and services from mainstream providers". There are 3 types of exclusions: (a) people who do not have any access to a regulated financial system; (b) people who have limited access to banks and other financial services; and (c) individuals who have inappropriate products. Financial exclusion can make poor people vulnerable to loan sharks. It breeds poverty and hinders overall development of a country. It not only widens the "Rich-Poor divide", it also leads to "Social exclusion". There are a variety of reasons for financial exclusion. The reasons are:

1. Lack of banking facility in the locality (i.e. geographical exclusion including a rural-urban divide);
2. Financial illiteracy;
3. Nonchalant attitude of the staff;
4. Cumbersome documentation and procedures;
5. Unsuitable products;
6. Language;

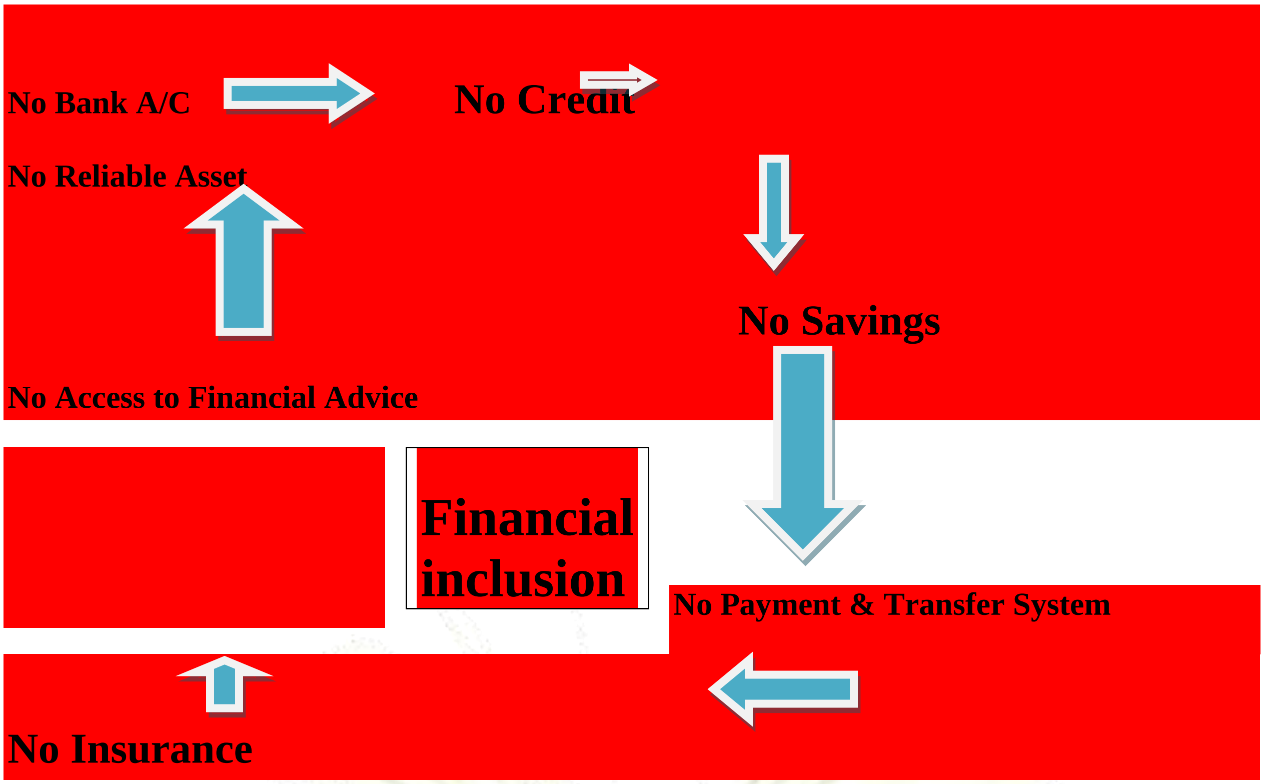
7. Feeling uncomfortable by a section of population in visiting a bank branch;
8. Lack of awareness and initial inhibitions in approaching a formal institution;
9. Low incomes/assets;
10. Distance from branch and branch timing and
11. Fear of refusal.

According to Report on Currency and Finance 2006-08 the critical dimensions of financial inclusion include access exclusion, condition exclusion(condition attached to financial products), price exclusion, and self-exclusion because of the fear of refusal to access by the service providers. The financial exclusion process becomes self-reinforcing and can often be an important factor in social exclusion, especially for communities with limited access to financial products, particularly in rural areas. Apart from the above mentioned supply side factors, demand side factors may also significantly affect the extent of financial inclusion. For instance, low level of income and hence low savings would result in lower deposits. Similarly, at low level of income, the ability to borrow is affected because of low repayment capacity and inability to provide collateral. In the Indian context, both demand and supply side factors have an important bearing on the usage of financial/banking services. There are supply side and demand side factors driving Inclusive Growth. Banks largely are expected to mitigate the supply side processes that prevent poor and disadvantaged social groups from gaining access to the financial system. Despite the risk, financing of first time entrepreneurs is a must for financial inclusion and growth.

Apart from the supply side factors, demand side factors, such as lower income and/or asset holdings also have a significant bearing on financial inclusion. Owing to difficulties in accessing formal sources of credit, poor individuals and small and macro enterprises usually rely on their personal savings or internal sources to invest in health, education, housing, and entrepreneurial activities to make use of growth opportunities.

The problem was that there was no risk mitigation mechanism for the poor people to whom banks lend. There are land-owning farmers, middle-level farmers, and farmers having less than 1hectare and landless people who are employed and landless people who are unemployed. Now, banks are going to finance them and there is calamity, there is loss. “There is no system in the financial sector, banking sector to care of the poor (under such circumstances)”. Banks and financial institutions had been till recent times financially excluding these people on the pretext that, 1) they have no or few assets. 2) They have nothing to offer as collateral. 3) They have no business experience. 4) They cannot be trained for available financial services. 5) They have no credit history and 6) They cannot understand the nuances of banking due to illiteracy or less education. 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.

Features of Financial Exclusion in India



Reaching out to the illiterate people or people who can handle only the regional languages is also difficult without developing a suitable communication mode. The challenge also lies in offering a single loan product which is not based on or linked to the purpose of the loan, the collateral or assets held or income earned by the household but is purely based on cash flow and credit record of the household (Thorat, 2008).

Know Your Customer (KYC) norms and Financial Inclusion

Fulfilling KYC norms also presents a hindrance in promoting financial inclusion in rural areas. Normally when an unbanked person in rural areas tries to open a bank account or to get insured there are three questions that are always asked: (a) What is your name – calling for identity proof, (b) What is your address – calling for address proof and (c) What is your occupation – calling for income verification. However, in the remote villages, it is a very difficult job to answer these questions with proof. Hence, the responsibility of the banks and other financial institutions regarding financial inclusion has to be seen in the light of the existing KYC norms. However, the RBI has reduced the stringency of the KYC norms for the purpose of promoting financial inclusion for persons who do not foresee having more than Rs.50000/- in all their combined bank accounts and whose annual total borrowing will not exceed Rs.1,00,000/- (Ramji, 2009).

Measures of Financial Inclusion

One of the measures of the level of financial inclusion is the Financial Inclusion Index. This index is based on three basic dimensions of an inclusive financial system –banking penetration, availability of the banking services and usage of the banking system. Banking penetration is definitely the most critical parameter for measuring the depth financial inclusion and is measured as a ratio of bank accounts to the total population. The second parameter, availability of banking services provides an indication to the number of bank outlets available per 1000 people to deliver financial services. The bank outlets may include the brick and mortar branches, ATMs, business correspondents, etc. The third parameter seeks to determine the usage of banking services going beyond mere opening of accounts. Therefore, this is evaluated on the basis of outstanding deposits and credits. Accordingly, the volume of outstanding deposit and credit as proportion on the net district domestic product is used for measuring this dimension. According to the value of the index, Indian States can be classified into three categories, i.e., states having high, low and medium extent of financial exclusion. According to the empirical results, Kerala, Maharashtra and Karnataka are some of the States having wider extent of financial inclusion as compared to other States of India. Tamil Nadu, Punjab, Andhra Pradesh, Himachal Pradesh, Sikkim and Haryana fall under the category of medium financial exclusion.

The extent of financial inclusion is found to be significantly low in North-Eastern and Eastern States, *i.e.,* Assam, Nagaland, Manipur, Odisha, Bihar, West Bengal, etc. Though the index and findings of the report in reference are based on empirical study, they are possibly not way off the ground realities.

State-Wise Index of Financial Inclusion

Kerala, Maharashtra and Karnataka	High level of Financial inclusion
Tamil Nadu, Punjab, Andhra Pradesh, Himachal Pradesh, Sikkim and Haryana	Medium level of Financial inclusion The all-India level falls in the medium FI category
North-Eastern and Eastern States, *i.e.*, Assam, Nagaland, Manipur, Odisha, Bihar, West Bengal,	Low level of Financial inclusion

Source: RBI Working Paper on Financial Inclusion in India: A case-study of West Bengal by Sadhan Kumar Chattopadhyay

Making Financial Inclusion a Success

There are several factors to be considered for inclusive growth. Uppermost among these is the need for raising the allocative efficiency of investment and resource use across different sectors of the economy- this can be met by addressing two basic supply-side issues viz.(1) effective credit delivery system to facilitate productive investment in employment impacting sectors especially, agriculture, micro small and medium enterprises, and (2) large scale investment in infrastructural facilities like irrigation, roads, railways, communication, ports, power, rural /urban reconstruction and in social infrastructure such as health care education and sanitation.

Financial inclusion is intended to connect the people to banks with consequential benefits. A decentralized strategy has been adopted for ensuring financial inclusion. A growing component of inclusive banking is the lending by Micro Financing Institutions (MFIs) that are societies, trust cooperatives or “non for profit” companies or non-banking financial companies registered with the Reserve Bank. Faster and more inclusive growth is the keystone of India’s 11th Plan (2007-12) and 12th plan (2012-17). There is no evidence of correlation between the speed of growth and its inclusiveness; but the sectoral composition in the growth matters in terms of ascertaining whether growth was more or less inclusive. Faster growth in service sector is associated with a larger gap between the consumption growth of the poor and the rich, in favour of the rich.

Financial inclusion is not just about opening "no-frills" accounts but also about providing small overdraft facilities, remittance and insurance products so that the bank providing the services achieves a faster break-even. Credit for the poor has to be looked into as a business proposition. "Around 60-70% of the people do not have a bank account and if one has to provide the same model of branch-less banking, the total cost to the exchequer could come to around Rs. 3000 crore. When the government can waive agricultural loans to the extent of Rs.60,000-70,000 crore, this is very small amount.

As first step towards inclusive growth, and is where we should start. Providing appropriate, transparent, cost-effective banking and financial products to the vulnerable group by mainstream institutional players. K. C. Chakrabarty is of the view that financial inclusion has to be done by the banking system. He emphasized that "we need to change the mindset of people and have the right technology in place. It is not just opening no-frills accounts; it is also just about extending an overdraft to such accounts and providing remittance facility. The focus should be on priority sector lending. Government subsidy, through various schemes should reach the right beneficiaries through their bank accounts.

Microfinance has the potential to positively impact millions of poor Indians. The next few decades could truly transform the nation through the largest financial inclusion programme in the history of mankind, duly supported by the government, policy-maker, regulators, bankers, investors and MFIs, and with the active involvement of client groups. By integrating 180 million poor households into the India growth story, the slogans of "Garibi Hatao" and "India Shining" can truly become a reality. Financial inclusion in Indian context implies the provision of affordable financial service, viz., access to payments and remittance facilities, savings, loans and insurance services by formal financial system to those who tend to be excluded.

The recent approach focuses on financial inclusion on the individual and household level. The important difference in the recent focus on financial inclusion is the adoption of market oriented approach that recognizes the importance of business consideration of bank and other financial institutions for the long term sustainability of the process.

The broad strategy for financial inclusion in India in recent years comprises the following elements:

(1) Encouraging penetration into unbanked and backward areas and encouraging agents and intermediaries such as NGOs, MFIs, CSOs, and business correspondents(BCs).
(2) Focusing on a decentralized strategy by using existing arrangements such as State level bankers Committee(SLBC) and district consultative committee(DDC) and strengthening local institution such as cooperatives and RRBs.

(3) Using technology for furthering financial inclusion.
(4) Advising banks to open a basic banking “no-frills “account.
(5) Emphasis on financial literacy and credit counseling and
(6) Creating synergies between the formal and informal segments.

In India, there have been several innovative experiments with various variants of micro-finance taking into account the highly localized needs. Small private sector bank design their credit schemes to suit the local requirements of productions, distribution and growth. They have devised innovative schemes to assist new entrepreneurs, small scale industries, agriculture, professionals, retail trade and small businessman. Local knowledge and informality is the keynote of their services. Even in globalization era, small banks can play a crucial role, particularly in rural India.

One of the successes in the last few years is supposed to have been the Mahatma Gandhi National Rural Employment Guarantee Scheme. It has increased financial inclusion because it is mandated into the scheme that payments are made through the job cards, through the bank accounts. Prior to this the scheme of “No-frills accounts”, as directed by the RBI paved the way for financial inclusion. It is a mandatory for state agencies to make the payments under various social schemes through bank account.

For inclusion there will be need for constant government support, both legally and institutionally. Financial education can help households in rural areas managed their finances more prudently with a view to maximizing returns. Financial inclusion must mean more than holding an account or increasing the savings rate at an aggregate level. Some of the steps suggested to make the policy of financial inclusion a success are:

1) Financial inclusion should focus on the saving needs along with the credit needs.
2) Have diversified product portfolio for the poor but recognize that self control problems need to be addressed by having commitment devices, and accordingly offer products with these features also. The products with commitment features should be optional.
3) Cut down transaction costs for the poor, by making innovative use of technology available and offering mobile vans with ATM and deposit collection features. These vans could visit the village periodically; say once in every two weeks.
4) introducing ‘Biometrics’ techniques in banking, particular in the operation of ATM; operations so that illiterate or semi illiterate people can utilized these services easily.

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Role of Banks towards Financial Inclusion

Banks in India are an integral part of financial system in India. The well-developed Indian banking system plays an important role in economic development of our country. The nationalization of banks, establishing of new banks with better reforms and policies and introduction of the numerous facilities and amenities of the Indian banks are significant features of the banking services of India. Technology and financial inclusion are the popular coinage in banking parleys in the country. Financial inclusion is a major agenda for the RBI. Without financial inclusion, banks cannot reach the unbanked. It is also a major step towards increasing savings and achieving balanced growth. In rural areas, where accessibility is a problem, banks are using the micro finance network and business correspondents and facilitators to bring more people under the ambit of banking services. The whole process of financial inclusion will not be possible without the contribution of banks. Banks are the key players of India's financial system. The nationalization of 14 banks in India took place in 1969 by Mrs. Indira Gandhi, the then Prime Minister. The banks are: Central Bank of India, Bank of Maharashtra, Dena Bank, Punjab National Bank, Syndicate Bank, Canara Bank, Indian Bank, Indian Overseas Bank, Bank of Baroda, Union bank, Allahabad Bank, United Bank of India, UCO bank, and Bank of India. The State Bank of India was nationalized in 1955. Nationalization of seven State Banks of India (formed subsidiary) took place in 1959. Seven more banks were nationalized in 1980 with deposits over 200 crores. Financial inclusion is now a common objective for many central banks. The banking sector takes a lead role in promoting financial inclusion. So for the last decades India's banking system has several outstanding achievements to its credit. The banks have reached even to the remote corners of the country. The period 1969 to 1991 saw a huge increase in the branch outreach in India as the average population covered by a bank branch fell from 64,000 to 13,711. The branches of commercial banks and the RRBs have increased from 8321 in the year 1969 to 68282 branches as at the end of March 2005. At the end of March, 2009, it has increased to 79442.

Many ways and means have been adopted but the fact still remains that it has to be a win-win situation, which means that both economically and politically it has become a compulsion for the commercial banks to increase their outreach, offering various products to the poor and marginalized and remain profitable at the same time. Keeping this in mind the RBI has permitted and recommended the use of some other channels of promoting financial inclusion to the commercial banks such as involving the self-help groups (SHG's), Micro-finance institutions (MFI's), Regional Rural Banks (RRB's), Non-Commercial Banks such as National bank for agriculture and rural development (NABARD), Non-Governmental Organizations (NGO's), Joint Liability Groups (JLG's), Co-operatives and Co-operative Banks. Even the other players in the financial sector like the Non-Banking Finance Companies (NBFC's), Insurance companies, and Mutual fund companies are expected to play a positive role in the process of financial inclusion throughout India. The commercial banks nowadays are in to selling of various products such as insurance, mutual funds, stocks and derivative products. Hence, it is quite evident that the banks in their own interest have taken the marketing position of the insurance companies and other NBFC's. So, the delivery of banking services would now actually mean the delivery of all kind of financial services to the poor and marginalized in partnership with the other entities.

Concluding Remarks

India has followed a multi-pronged strategy to promote financial inclusion. The global experience also suggests that countries that allow diversity in approaches are more likely to achieve better results. Diversity in approaches not only serves better the diverse demand for financial services, but also reduced systematic risks, increases competition, and improves efficiency. The operating cost of financial inclusion is perceived to be high as compared with returns from the services extended to low income groups. Banks, therefore, are generally averse to voluntarily extending financial services to such segments.

Banks have to undergo a statutory audit every year apart from the internal audit system that they possess. The bank auditors seldom are found to make comments on the state of affairs of the work done by banks on promoting financial inclusion. The RBI may also include such provisions, which would enable the auditors to examine and make comments on the banks role in the process of financial inclusion with absolute facts and figures. It is also suggested that the RBI has a rating procedure of the commercial banks not only on the basis of financial performance but also on the basis of their achievements in the process of promoting financial inclusion in the state. The RBI may also have a scheme where a minimum level of efficiency in this matter becomes mandatory, failing which penalties would be imposed as in the case when banks fail to meet the cash reserve ratio.(CRR). Taking such precedence of regulations the RBI, may also fix the reverse repo rate of various banks on the basis of their performance in the area of financial inclusion on a year to year basis. This would obviously put psychological pressure on the commercial banks to act significantly in the direction of financial inclusion. The higher the level of performance of the commercial banks in the area of financial inclusion, higher would be the reverse repo rate applicable for that particular bank, thus generating additional income.

The faster and inclusive growth should be achieved simultaneously rather than in a phase manner. Strategies of growth and equity must be integrated and we must frame "macro pro-poor policies and people-centric policies". However, the challenge in India is not policy formulation or finding the money, rather it is making the government machinery execute policy well-whether it is an employment guarantee scheme or an immunization programme, running public schools or doing agricultural extension work. "The duality is between reformed markets and unreformed government. The former helps more those who are in the market, the latter is unable to help those left out the market forces".

In fact, inclusion has become essential because of its implications for the welfare of citizens and because it is an essential strategy for fostering economic growth. The usage of terms like credit inclusion, economic inclusion, social inclusion and financial inclusion have today become part of the parlance of decision-makers striving to chart out a path for overall economic growth. Financial inclusion is of no use if it fails to provide livelihood to the poor. Inclusion projects have to go beyond experiments and look at fiscal viability and financial literacy also. Clearly, financial inclusion could no longer be treated as an outreach of social development programme. Instead, it should be treated as a successful business model.

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