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ADVANCING FINANCIAL INCLUSION IN INDIA BEYOND THE JAN-DHAN YOJANA

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We look forward to active engagement with readers on the diagnoses and recommendations that these papers offer. Feedback can be sent directly to the authors.

Advancing Financial Inclusion in India beyond the Jan-Dhan Yojana

Key Insights

- Promote financial savings of poor households through innovative product design that matches their specific needs
- Bring indigenous 'bottom-up' financial institutions such as registered Chit Funds, and the extensive postal network into the fold of national financial inclusion strategy for greater impact
- Extend effort to pilot innovative insurance products and scale up successful insurance instruments
- Encourage technology solutions that reduce operating costs of selling small ticket financial instrument and support innovations in management practices of financial institutions to enable sustainable and robust financial inclusion
- Galvanize financial literacy and awareness for better utilization of financial instruments and to reduce risks of dubious schemes

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Introduction

In a laudable move, the new government of India has made financial inclusion a key objective for the country. The Finance Minister, in his budget speech for 2014-15, laid out a specific set of targets to provide for financial accounts to every household by August 2015. This ambitious target set the tone as well as highlighted the importance of attaining it within a specified timeframe. Taking the ambition further, in his maiden Independence Day speech, the Prime Minister announced the Pradhan Mantri Jan–Dhan Yojana (PMJDY) with an objective of opening no-frills bank accounts. The PMJDY was launched immediately after this announcement on August 28. On the inauguration day itself, 1.5 crore bank accounts were opened. Within three months, the figure multiplied to 7.5 crore across India. This must be recognised as a remarkable achievement.

The focus of financial inclusion in India thus far has overwhelmingly been on delivering credit through microfinance channels, state-owned banks and through state-promoted self help groups. The PMJDY has complemented these efforts by forcefully accelerating the previous efforts of the Reserve Bank of India (RBI) of promoting financial inclusion through facilitating opening of bank accounts. The PMJDY provides basic zero-balance bank accounts with accident insurance cover of 1 lakh, along with an overdraft facility of Rs 5,000 available for account holders. The scheme would also facilitate the use of mobile banking among the poor through the National Unified USSD Platform (NUUP). The NUUP would allow customers to access banking services using a single number across all banks, irrespective of the telecom provider or mobile handset being used (National Payments Corporation of India, 2014). The launch of this scheme received strong support from public sector and private sector commercial banks, resulting in significant uptake. With the provision of insurance and transfer facilities along with the overdraft facilities under PMJDY, there is a clear focus on expanding the portfolio of financial instruments available to all households in the country (Pradhan Mantri Jan–Dhan Yojana, 2014).

Just about a year ago, the RBI renewed its financial inclusion mandate with the formation of the Mor Committee on Comprehensive Financial Services for Small Businesses and Low Income Households in September 2013. The committee, whose objective was to provide a clear vision for financial inclusion, prepared a report highlighting key areas of concern. The recommendations of the committee included provision of bank accounts to all citizens, setting up state finance regulatory commissions and creation of a new entity in the financial system - payment banks.

Since then the RBI has issued two new full bank licenses and, in November 2014, released final rules for setting up small banks and payment banks. Small banks will provide both deposits and loans, but geared towards un-served and underserved segments such as small businesses and marginal farmers. Payment banks will offer a limited set of products, mainly demand deposits and remittances and transfers, and will not provide lending services.

The recent policy measures undertaken by the Government and RBI have provided a much needed push for financial inclusion in the country. However, there remain some key gaps and concerns that must be addressed for attaining sustained comprehensive financial inclusion, especially of the low-income population. We highlight these and discuss them in some detail in this paper.

A Brief Background of Financial Inclusion in India

After the World Wars, most developed nations vigorously implemented rural finance policies, which focused primarily on the provision of subsidised credit to the rural population, through state-controlled or directed institutions. Indian policies on rural finance have mirrored the worldwide pattern since the 1950s with the implementation of various forms of subsidised credit schemes, including the mammoth Integrated Rural Development Programme (IRDP). The basis of extending subsidised credit is the theory in development economics which claims that access to capital can lead to increased income and reduced poverty. The critical assumption of that model is that all households have a project to invest in and it is only the lack of collateral that prevents banks from lending to the poor. It was exactly this fundamental logic which led to the innovation of different kinds of collateral substitutes like joint liability which formed the basis for the microcredit revolution worldwide, particularly in South Asia.

However, it is now well recognized that financial needs of the ‘excluded’ segments of the economy go beyond access to credit. Improved access to various formal financial services includes safe instruments for savings, easy-to-understand insurance instruments, and pension and transfer facilities, among others. These can enable consumption smoothing, building an asset base which can facilitate future access to credit and risk management and be used for self-investment in micro enterprises.

The main demand-side barriers to the provision of financial services to the poor are the lack of awareness, limited financial literacy, and limited access. Most products offered by banks are unsuitable

for the poor and come attached with terms and conditions which prove to be burdensome, further dampening the demand for these services. At the same time, as recent events (for example, the Saradha scam) have shown, lack of financial literacy can result in people making wrong choices, and becoming vulnerable to excessive financial risks.

From the supply side, the main barrier to the provision of formal financial services is transaction cost. Data reveals that a large number of bank accounts are underused, which makes creating and maintaining such accounts cost-ineffective for the banks. From the credit perspective, the lack of collateral makes lending to small borrowers costly for banks and other formal financial institutions. Small ticket sizes add to the per instrument transaction costs. Furthermore, lacunae in physical and legal infrastructure make it difficult to extend and enforce contracts.

What do the poor want?

Most of the poor, urban and rural, lack access to basic financial services and address their need for financial products through informal means which are costly and unsecure. Financial inclusion aims to reduce such risks, and provide safer options to them, but over the years the various policies adopted by the government to increase the presence of banks in remote rural areas have still not been able to cover the majority of the population. Those who have been provided with no-frills bank accounts lack the incentive to utilize these accounts to save money. Most of the strategies of the government in promoting financial inclusion have been centred on the provision of bank accounts in order to facilitate credit to the poor. The provision of credit, though important, is not the only means through which the poor can be included in the economy through financial services.

Understanding how the poor earn and manage their money can help in designing better instruments and institutions to address their financial needs. In *Portfolios of the Poor*, Collins et al. (2009) aim to do this through the use of 'financial diaries'. The authors interviewed poor households in Bangladesh, India, and South Africa twice a month for a year, asking a series of questions which were then constructed into 'financial diaries' to understand how the poor spent their money. The poor in developing countries like India, face three main issues or a 'triple whammy' — low incomes, lack of appropriate financial tools, and unpredictable outcomes. It is these challenges which financial

inclusion initiatives must address. This research found three main areas where poor households would frequently find the need to generate resources through financial tools.

Lump sums of cash: In order to invest in microenterprises and agricultural activities, the poor need to generate large sums of money to purchase fertilizers or invest in human capital such as healthcare, school fees and weddings. However, there are constraints on the ability to generate such large sums. Hence, they require financial instruments that meet these needs by helping them 'save up' to a lump sum amount.

Daily expenditure: Funding for day-to-day expenditure is a need that the poor face, and is often unaddressed by the financial institutions, unlike the provision of lump sum of money. This need is most acute for those farmers who receive a few lump sums over the year. However, these sums of money are almost immediately used up. There is a need to set some money aside in the months of no income and also for future expenditure. This need is also important for other categories of workers who receive intermittent income, like daily labourers, in order to bridge gaps in earnings. Therefore, the provision of financial services, such as savings bank accounts, can be instrumental in cash flow management for households. Having secure and accessible savings accounts can help them in consumption smoothing to a great extent.

Unexpected circumstances: A situation in which the poor often find themselves unable to provide are unavoidable crises like adverse weather conditions and health emergencies. These negative shocks drive the marginal poor back into poverty by forcing them to resort to borrowing from informal sources such as moneylenders or to sell assets. Risk exposure can also dis-incentivise them from investing in activities which could yield higher productivity. Access to insurance instruments as well as savings can provide a buffer in times of extreme shocks such that they don't resort to costly income–smoothing activities.

Advancing Financial Inclusion in India beyond Jan–Dhan Yojana

With most financial inclusion policies in India solely focused on the provision of bank accounts and credit to the poor, there is a need to include more financial services in the portfolio of national financial inclusion strategies to account for the needs of this segment. We highlight some of these below and emphasize that they be prioritized.

1. *Innovation in savings instruments*

The financial portfolios of poor households are as diverse as those of their richest peers, with an average of 10 financial instruments per household (Collins et al., 2009). However, the diversity of financial instruments offered in India today by commercial finance companies as well as the government is limited in scope and scale, particularly to the poorer sections of society. Product design is critically important when it comes to developing savings instruments for low-income households. The instruments provided and facilitated by the financial sector, from the government to the banks to local state authorities must be designed according to the needs of the specific market segment.

Internationally, the success of Bank Rakyat Indonesia (BRI) in providing commercially viable financial services – loans and savings, along with other financial products to the low-income households – has several lessons for India. BRI built a customer base of over 30 million depositors through tailoring their products and services offered to the needs of the clients, thereby incentivizing them to better utilize their savings accounts. BRI accounts are structured in a way which encourages more savings than loans. The management practices at the BRI have also been innovative such that each bank unit (branch) functions as an independent entity with its own targets and employee reward policies. These innovations in product and management practices have collectively made the BRI a long term profitable bank with the distinction of being one of the few large banks in the region which survived the East Asian financial crisis. Thailand's largest state owned bank- Bank of Agriculture and Agricultural Cooperatives (BAAC) -followed BRI's lead and there are discussions of bank reforms in China along the BRI model.

Another savings product that received tremendous attention was developed to incentivize the poor and is called the SEED (Save, Earn, and Enjoy Deposits) account, implemented by the Green Bank of Caraga in the Philippines (Ashraf et al., 2006). The SEED account provides individuals with a commitment which restricts their savings. The individual sets a goal, either a date or amount he/she wants to save, and is subsequently unable to withdraw money from the account until that goal is reached. Such measures give people the option to 'force' themselves into saving and it also stresses the importance of longer term financial goals and discipline for households. These are critical for the development of viable financial markets at the bottom of the pyramid.

Extending products from the mainstream financial sector into the financially excluded segment can be risky. Financial institutions must be encouraged to develop innovative products and services, and

move away from the one-size-fits-all recipe. This can be achieved through encouraging innovation and ensuring competition amongst the financial service providers in India.

2. *Indigenous institutions of financial inclusion*

Research has shown that Chit Funds are widespread in India and have the appeal of a "bottom-up" approach to financial inclusion, aimed at providing low-income households the means through which they can meet their financial needs. However, these institutions have so far been excluded from the formal financial sector, largely due to ignorance. In most parts of India, very large groups of people participate in different forms of informal regular savings-credit arrangements with each other. Under a chit fund scheme, a group of individuals comes together and pool in money, and at the end of each month (or a specified period), the pool of money is loaned out to individuals from among that group. In this aspect, it acts as an efficient circulation of money between those who want to save and others who want to borrow. It also serves as an accessible option of insurance during financial duress.

Chit Funds in India have been in operation for thousands of years – they were first established as informal associations of traders and households within communities. They work in a similar way to the Rotating Savings and Credit Associations (ROSCA) which are prevalent in most countries of the world, in some form or the other, allowing people to save and borrow simultaneously. India has formally institutionalized Chit Funds through the Chit Fund Act, 1982, enabling legally recognized institutions the means to provide a variety of chit schemes. The industry under the Act is highly regulated with stringent rules in place.

According to a report by the Institute for Financial Management and Research (IFMR) (Kapoor et al., 2011), more than 90% of the population surveyed held bank accounts. To be able to participate in chit funds, a person should hold a savings account wherein cheques can be deposited — almost everyone in the states surveyed have savings accounts. However, according to an RBI study, 87% of these accounts in a particular district were inactive. Banks have little incentives to promote the use of such savings accounts. The RBI had promoted the use of no-frills bank accounts which require a low minimum balance, and banks perceive such accounts to be less than desirable. It was also found that Chit Funds are the preferred mode of savings for over 40% of members, with 11% of the overall population preferring them for loans due to lower interest rates compared to banks.

The most common reason for participating in Chit Fund schemes was to save, with consumption and/or business requirements a close second. The requirements change with the income levels of the individual. As the income level of members increase, the proportion of people bidding in these chit schemes for business investment increases, though the opposite holds true when it comes to consumption needs. The results from the research study show strong positive implications for Chit Funds as a source of savings and borrowing for poor households in India.

It is now well established that Chit Funds are catering to those segments of the economy which are yet to be satisfactorily catered by Microfinance Institutions and Banks. They have tremendous potential to complement economic policies aimed at promoting entrepreneurship at low income levels and facilitating growth. They must, therefore, be part of the national financial inclusion strategies of the government.

The policy recommendation is to recognize the importance of Chit Funds and to galvanize financial literacy among the investing public, media and financial regulators – with an aim to educate them about the difference between Chit Funds and other deposit taking companies like Collective Investment Schemes, Multilevel Marketing Companies and Prize Chits. A critical first move in this direction would be to initiate the Amendment of the Chit Fund Act 1982, making it more user friendly and thereby encouraging the unregistered sector to fall in line with the organised sector.

Our analysis of a recently conducted geo-spatial survey of financial service providers[1] in Uttar Pradesh and Bihar shows that households have the best access to post offices, measured in physical distance. On an average households are 2 kilometres from the nearest post office while the distance to the nearest bank customer service point is 1.5 times as much; the distance to ATMs is 3 times as much while the nearest MFI is more than 10 times farther. This would suggest that financial inclusion strategies of the government should ideally leverage the already existing and extensive postal network in the country. Post offices offer few financial services currently but these must be augmented. Particularly because the original mandate of postal department has weakened with improved digital and telecom footprint across India.

3. *Insurance instruments*

Insurance is a critical component for financial inclusion of the poor, vulnerable sections of the population. It has not enjoyed the same prominence in policy measures as credit and bank accounts

[1] Survey conducted by Brand Fusion and supported by Bill and Melinda Gates Foundation

in India. As mentioned previously, the main needs for the poor are to have safety nets in order to provide for any unexpected circumstances, to hold lump sum money, and to provide day-to-day expenses. Besides tapping into savings, these needs can only be met through well-designed and easy-to-understand insurance products, including health, life, property, crop and myriads of other insurance instruments meant to mitigate different forms of shocks.

Our previous research indicates that though the access to credit and savings instruments can serve as insurance mechanisms along with societal arrangements of reciprocity, these are expensive in comparison to access to insurance instruments (Ravi, 2006). The new PMJDY provides some forms of insurance but is limited to accident and life. Launched in 2008, Rashtriya Swasthya Bima Yojana (RSBY) aims to provide health insurance coverage to all below poverty line (BPL) families in India. Till date more than 37 million BPL families have been enrolled in this health insurance scheme but it remains to be seen whether it is an effective tool to protect poor households from health shocks. Previous research has shown that limited understanding of health insurance results in a significantly lower claims to coverage ratio for the low income segment (Ravi & Rai, 2011).

The Agriculture Insurance Company was set up in 2002 with the sole motive of promoting insurance cover to farmers in India. They have since rolled out three main schemes – yield based national agriculture insurance scheme, national crop insurance program and the weather based crop insurance scheme. Given that crop insurance has suffered financially at the global level, it might be worthwhile to take stock of India's performance. Also, insurance cover to the rural poor has to extend beyond crops to livestock, property and weather insurance because a significant part of the rural population is employed in microenterprises and face income shocks. Government effort should be extended towards pilot testing these products and scaling up those financial instruments that have proven to be successful.

Some sophisticated insurance products like the weather insurance (rainfall insurance) have fallen far short of the intended take up levels, despite being well designed. The common belief is that lack of financial literacy and awareness makes selling insurance instruments a tricky business and often a prohibitively expensive one, particularly to the poor. People are often confused between savings and insurance instruments and there have been several reported instances of poor households wanting to withdraw their insurance premiums.

4. *Technology*

Technology has been the key in reducing the problem of access to banking services, and with schemes such as the PMJDY, providing access should not be among the major challenges. The technological options are now wide ranging, and with India's booming telecom sector, the option of using mobile payments as a means for financial inclusion is feasible. According to the latest data released by the Telecom Regulatory Authority of India, the total number of mobile subscribers in India is around 900 million. Therefore, telecom companies have emerged as a viable tool to achieve financial inclusion. In Kenya, M-Pesa is one example of how mobile technology is used to complete banking transactions. The core idea of businesses such as M-Pesa rests solely on the facilitation of financial transactions via mobile phones. Under this system, customers can transfer money directly between accounts as well as between other customers as well, as long as both parties have M-Pesa (Kapoor et al., 2007).

Conclusion

Expanding access to financial services seems to hold promise as a means for including the poor, reducing poverty, and spurring economic development (Karlan & Murdoch, 2010). With the announcement of the SVS financial inclusion blueprint by the government under which the PMJDY was launched, and the new payment bank guidelines suggested by the RBI, there is hope that financial inclusion is a clearer and important mandate in the country. Both these measures emphasize the provision of bank accounts, which is an essential factor, but only a limited one towards achieving financial inclusion in India.

In the past decades, state policies of financial inclusion have overwhelmingly relied on extending credit to low-income households through subsidized credit schemes like IRDP or expanding SHGs and providing no-frills bank accounts. Private sector initiatives like the significant expansion of microfinance activities in India have also shown the limited scope within which lenders functioned. Research has shown that unless financial instruments are designed for specific needs of the poor, they remain underutilized and costly for the providers, and therefore, non-sustainable. Broader financial needs of the poor have so far been met through informal means which are costly and risky and result in sub optimal outcomes for the most vulnerable sections of our society. Allowing and encouraging

innovation in savings instruments for the poor by the formal financial sector is thus critical to achieving our goals of financial inclusion.

To complement such innovation, indigenous financial institutions must find a place within the financial inclusion policies of the government. These are old institutions based on established social networks. Our policies must incorporate these and facilitate further healthy growth of such indigenous institutions. We must also actively seek to understand these institutions to shape a regulatory policy rather than shun all out of ignorance. They have a far greater reach and acceptance amongst the people than most top-down policies of financial inclusion in the recent history of liberalized India. Government policies must recognize this and build on the strengths of indigenous financial institutions. For similar reasons, post offices must also be brought within the fold of national financial inclusion strategy due to their extensive network and greater accessibility.

Raising awareness and imparting financial literacy are also critical to the utilization of financial instruments and for better financial decision-making. Educating people about financial risks can prevent them from investing in dubious schemes. Such schemes are particularly rampant amongst the poor and vulnerable sections of the Indian society, as recent scams have highlighted. Regulation should also ensure customer protection and transparency through requirements of clear and standardized reporting by the sellers of financial instruments.

Technology must be leveraged to bring down the operating costs of these financial instruments which are more expensive in comparison to larger ticket instruments of the mainstream financial sector. Innovation in the financial sector- through greater autonomy and competition must be encouraged. Institutions should have the autonomy to experiment with management practices as well as financial products which can help offer sustainable solutions to the financial needs of all segments of the Indian economy.

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