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"Financial Inclusion" in India: Ambitious but Ambiguous Plan

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Jan Dhan Yojana (People's Wealth Plan) – an ambitious financial inclusion program – was launched amid much fanfare in India on 28th August, 2014. The initial target of Jan Dhan Yojana is to cover 75 million unbanked households by 26th January, 2015. The government claims that on the inaugural day, a record 15 million bank accounts were opened across the country under this initiative. Nowhere else in the world, such a large number of bank accounts have been opened on a single day. In less than a month, nearly 40 million accounts have been opened under this initiative.

The Jan Dhan Yojana (JDY) would be implemented in two phases. In the first phase, the aim is to provide universal access to banking facilities through a business correspondent or bank branch, zero-balance bank accounts with overdraft facility of Rs.5,000 after six months and RuPay debit card (domestic card payment network which competes with MasterCard and Visa) with inbuilt insurance cover of Rs.100,000. Those who open accounts by January 26, 2015will be given life insurance cover of Rs.30,000. In the second phase starting from 15th August 2015, the focus of JDY would be to provide additional financial services such as micro insurance and pension schemes meant for unorganized workers.

The government claims that the JDY is a major departure from the earlier initiative launched in 2005 which was primarily aimed at promoting financial inclusion in the rural areas with focus on the coverage of villages. Whereas the JDY aims to provide banking services in both rural and urban areas with focus on the coverage of individual households. One of the new features of JDY is the creation of local monitoring committees and a web-portal to monitor its implementation at the national level. The JDY is being run in a mission mode with the Finance Minister as head of the mission.

What is Financial Inclusion?

Even though there is no universally accepted definition of financial inclusion (FI), it has become a buzzword in development circles lately. From Queen Maxima of the Netherlands to World Bank to G20, everyone espouses the concept of financial inclusion. In simple terms, financial inclusion means delivery of banking services (such as savings accounts, loans, remittance and payment services) at an affordable cost and in a convenient manner to the poor and marginalized sections of society.

For India, financial inclusion has become a key policy concern as there are over 600 million citizens who lack basic banking and financial services. In India, financial exclusion has strong linkages with poverty and is predominantly concentrated among the vast sections of disadvantaged and low income groups. One of the important factors behind rising farmer suicides in the countryside is the lack of access to cheap credit from banks and institutional sources.

In India and elsewhere, financial exclusion is not merely restricted to rural population. A large number of urban dwellers, migrants and informal sector workers also lack access to banking and other financial services.

The JDY is not the first major initiative to promote financial inclusion in India. It should be rather viewed as financial inclusion 3.0 – as two policy initiatives on FI were launched previously.

Financial Inclusion 1.0

After independence, the first initiative on financial inclusion was launched in July 1969 when 14 of the largest privately-owned banks were nationalized. The bank nationalization marked a paradigm shift as the policy aim was to take the banking services to poor people. Before nationalization, privately-owned banks were located in metropolitan and urban areas. Much of bank lending was concentrated in a few organized sectors of economy and limited to big business houses and large industries. Whereas farmers, small entrepreneurs, laborers, artisans and self-employed were totally dependent on informal sources (mainly traditional moneylenders and relatives) to meet their credit requirements. The share of agriculture in total bank lending was a meager 2.2 percent during 1951-67.

There were several policy objectives behind the bank nationalization strategy including the transformation of “class banking” into “mass banking,” expanding geographical and functional spread of institutionalized credit, mobilizing savings from rural and remote areas and reaching out to neglected sectors such as agriculture and small scale industries. Another policy objective was to ensure that no viable productive business should suffer for lack of credit support, irrespective of its size.

Rapid Expansion of Branch Network in Unbanked Locations

At the time of nationalization, scheduled commercial banks had 8,187 branches throughout the country. But in 1990, the branch network increased to 59,752. What is even more important is that out of 59,752 bank branches, 34,791 (58.2 percent) were located in the rural areas. In contrast, the share of rural branches was 17.6 percent in 1969. Such a massive expansion of bank branches in the rural areas was the result of 1:4 licensing policy under which banks were given incentive to open one branch in metropolitan and one branch in urban areas, provided they open four branches in the rural areas.

In the early 1970s, the concept of priority sector lending (also known as directed lending) was evolved to ensure that adequate credit flows to the vital sectors of the economy and according to social and developmental priorities.

In addition, the establishment of regional rural banks (RRBs) in the mid-1970s also widened the reach of banking services. The RRBs were jointly owned by the central government, the state government and the sponsor bank. Between 1975 and 1987, 196 RRBs were established in the rural India. The mandate of RRBs was to serve small and marginal farmers, agricultural laborers, artisans and small entrepreneurs in the rural and remote areas. Further, banks were directed to maintain a credit-deposit ratio of 60 percent in the rural and semi-urban branches in order to ensure that rural deposits are not used to increase urban credit.

In rural areas, there was significant rise in bank deposits and credit. According to official data, the share of rural deposits in total deposits increased more than five times, from 3 percent in 1969 to 16 percent in 1990. The share of agriculture credit in the total bank credit increased from 2.2 percent in 1968 to 13 percent in 1980 and further to 15.8 percent in 1989. The share of small-scale industry in the total bank credit which was negligible before nationalization reached 15.3 percent in 1989, a significant achievement by international standards.

There is no denying that the banking system under the nationalization regime was not perfect as it could not reach out to each and every household but at least a serious effort was made to spread banking services: geographically, socially and functionally. There are very few parallels in the history of banking in the world where such large-scale geographical expansion and functional diversification of the banking system (with social and developmental orientations) took place within a span of two decades.

Admittedly, there were cumbersome lending procedures, inadequate supervision, corruption and political interference which affected functional efficiency and profitability of the banking system. Nevertheless, the bank nationalization drive was inspired by a larger objective to promote social and development banking in India.

The Neglect of Financial Inclusion under Banking Sector Reforms

One of the adverse consequences of banking sector reforms launched in the 1990s was the steady decline in the number of bank branches in the rural India. During 1994-2006, bank branches in rural areas were closed down to meet the profitability criteria and to achieve higher efficiency levels. In absolute terms, the total number of rural bank branches declined from 35,329 in 1994 to 30,119 in 2006. In other words, as many as 5,210 bank branches in the rural India were closed down during 1994-2006. On an average, two bank branches were closed down on each working day during this period.

On the other hand, a rapid expansion of branches in the metros and urban areas has been witnessed in the post-liberalization period. According to the Reserve Bank of India (RBI) statistics, 5,960 new branches were opened in the six metros during 1994-2006.

In 1994, the share of rural branches was 57.16 percent but it declined to 37.18 percent in 2013, indicating the worsening of the rural-urban ratio of bank branches in the post-liberalization period.

In the 1990s, the banking sector witnessed a secular decline in agricultural credit. This is in sharp contrast to the 1970s and 80s when a significant shift in bank lending in favor of agricultural sector took place. The proportion of bank credit to agriculture and small sector industries declined from 30 percent in 1994 to 18 percent in 2013, despite several initiatives launched by the government to revive bank credit to these sectors which generate largest employment opportunities in the rural areas. The share of deposits raised from rural areas declined from 15 percent in 1994 to 9 percent in 2012. All these statistics reveal a sheer neglect of the banking needs of people living in rural and semi-rural areas during the post-liberalization period.

Financial Inclusion 2.0

Concerned over these adverse developments, another initiative towards FI was launched in

2005 with greater emphasis on branchless business correspondent model to provide last mile connectivity to unbanked villages.

In 2005, the RBI pushed banks to provide a “no-frills” zero-balance account with minimum charges for other services. Other major policy initiatives under this drive included relaxation in know-your-customer (KYC) norms, easier credit facility, introduction of General Purpose Credit Card (GCC) and support to microfinance institutions and Self Help Groups.

The focus on FI was further intensified in 2009 when the RBI directed banks to draw up a road map to cover nearly 74,200 villages with more than 2,000 population with one banking outlet by 2012. To achieve this target, several new regulatory measures were introduced. For instance, the domestic banks (both public and private) were given freedom to open branches in Tier-2 to Tier-6 centers without prior approval from the RBI. In order to encourage banks to open branches in the predominantly unbanked North-East region, domestic banks were allowed to open the branches in rural, semi-urban and urban centers without the prior approval from the RBI. Later on, banks were mandated to open at least 25 percent of their new brick-and-mortar branches in the unbanked rural areas.

Under the financial inclusion plans adopted by banks, 7,459 new branches were opened in rural areas in three years during 2010-13. However, this period saw the domination of banking correspondents (BCs) to provide banking services to unbanked population. Most of the villages covered under this drive were through BCs. As discussed in more detail below, the BC model failed to adequately accomplish its intended purpose despite a rapid increase in its outreach.

Misplaced Emphasis on BC Model

A business correspondent is a representative of bank who provides doorstep banking services through the use of smart card handling devices which are connected to the main servers of the bank. The handheld device can identify the bank customer through finger prints and facilitates basic transactions such as depositing and withdrawing cash. The RBI has allowed banks to use the services of NGOs, microfinance institutions, non-banking finance companies and post offices as BCs.

Since 2006, the policymakers have supported the expansion of banking services through BC model on the pretext that it provides services at the doorstep of customers living in unbanked locations and reduces the costs involved in putting up and operating a brick-and-mortar branch.

There is no denying that the BC model has expanded its reach across the country in the last eight years. The RBI’s annual report for 2013-14 notes that “nearly 248,000 BC agents had been deployed by banks as on March 31, 2014 which are providing services through more than 333,000 BC outlets.” Close to 117 million zero-balance accounts have been opened up by the BCs as on March 31, 2014. In addition, there were 60,730 BC outlets in urban locations as on March 31, 2014.

These are pretty impressive numbers. But empirical evidence from Sundergarh in Orissa to Surendranagar in Gujarat suggests that access to bank accounts has not translated into use. More than 80 percent of zero-balance bank accounts are dormant.

In cases where customers receive wages under the National Rural Employment Guarantee

Act (NREGA), they simply withdraw the entire amount immediately after the NREGA disbursement. Not even 5 percent of zero-balance account holders make deposits into their bank accounts. If people are not actively using their bank accounts, it defeats the very purpose of financial inclusion.

Banks, on their part, are not interested in promoting awareness activities on the usage and benefits of formal banking services as they lose money on zero-balance accounts due to few transactions and low balances. Most banks view zero-balance accounts as a corporate social responsibility thrust upon them by the government. For banks, serving poor clients is a social obligation rather than a viable business opportunity. With the result, the potential benefits of access to formal banking services are not fully realized.

The Inherent Weaknesses of BC Models

Some caution is obviously warranted because the JDY relies heavily on the BC model for expanding banking network in both rural and urban areas. One of primary reasons behind the unsatisfactory performance of BC model is the poor remuneration (Rs.2000-3000 per month) paid to business correspondents. For such a meager amount, it is unfair to expect a BC to visit villages or slums at regular intervals, open new bank accounts for poor people, process financial transactions, educate customers about banking services and answer all queries of the customers. With the result, there is a high attrition rate among BC agents across the country. Surveys have found that more than half of BC agents are untraceable.

Under the JDY, the BCs will get a minimum compensation of Rs.5000 per month. This is a welcome move but there are several other important factors which act as a barrier in the delivery of banking services through BC model. Some of these factors include inordinate delay in issuing of smart cards to customers (three to six months); limited utility of smart cards as services such as remittance are not loaded; inadequate cash handling limit given to BCs; devices not working properly due to technical problems or poor network connectivity; lack of trust in BCs; lack of customer-centric banking products and services; poor governance and inadequate supervision of BCs; and absence of a comprehensive strategy for financial education.

If these impediments are not addressed, the JDY may turn out to be another government program under which ambitious targets of opening millions of bank accounts are achieved on paper but very little meaningful financial inclusion is actually accomplished on the ground.

It is imperative that the policy focus should shift from the quantity of inclusion to the quality of inclusion. The success of the JDY should not be measured only on the basis of number of new accounts opened. The measure of success should also include clearly defined targets for usage and transactions.

The JDY Should Emphasize on Physical Branches

Given the unsatisfactory outcomes of the BC model, the JDY should give greater emphasis on brick-and-mortar branches which enjoy a high degree of trust and acceptability among the rural people. Besides, there are several transactions (e.g., loans) require physical branches and direct interaction with the bank officials.

In a rural setting, a mini-branch (consisting of two staff persons) can easily serve 4-5 villages and provide a full range of banking services. This would ensure that the villagers will no longer have to take substantial travel and expense to visit a mini-branch. A mini branch linked with a nearest large branch could function as a hub-and-spoke system. In Andhra Pradesh, for instance, HDFC bank has recently established several mini-branches and found it to be a commercially viable model to offer full banking services to rural people.

The last-mile connectivity is very crucial for the success of JDY. Given the large outreach of post offices across the country, postal networks could be explored to provide banking products and services at a low cost.

Like “Post Office on Wheels” which provides a variety of postal services through a mobile van in the country, the mobile van banking is another credible delivery model which could be used to serve large customers located in the far-flung rural areas at regular intervals.

Other Pertinent Questions

During a recent visit to my bank located in East Delhi, I found that many low-income customers enrolled under the JDY already had zero-balance accounts in another bank. They have opened new accounts under the JDY scheme to avail special privileges of overdraft facility, insurance covers and a RuPay debit card. While they had opened bank accounts last year to receive LPG subsidy under the direct benefit transfer (DBT) scheme. Currently there is no system in place to ensure that one person does not open multiple bank accounts.

In another bank, I found that the bank staff is demanding a minimum deposit of Rs.500 for opening an account under the JDY. If such practices are widespread in a metropolitan city, one can well imagine the actual implementation of JDY in the rural and remote areas.

The JDY will be spearheaded by domestic banks (both state-owned and private) though the bulk of task would be carried out by state-owned banks which have over 43,000 branches in the rural and semi-urban areas. It is heartening to note that the government has realized the importance of state-owned banks in promoting inclusive development despite a strong anti-statist slant.

But why there is no participation of foreign banks in JDY? Why foreign banks have not been directed to join the JDY initiative? There are 43 foreign banks operating in India with 332 branches and 1207 ATMs. Since 95 percent of their branches are located in the metros and urban locations, foreign banks should be given targets to serve the urban poor. This would induce foreign banks to tweak their niche banking model as they “cherry-pick” the most profitable businesses and affluent customers residing in the metros and urban areas.

Will JDY Cause a Financial Burden?

Some commentators have questioned the financial feasibility of the JDY on the grounds that the estimated costs involved in its implementation will be a drain on the entire banking system. Such concerns are unconvincing on four counts. Firstly, banks in India have not accurately worked out the per account cost. As K C Chakrabarty (former deputy governor of the Reserve Bank of India) has pointed out, costing is opaque in the banking services and therefore it is very difficult to determine the exact cost of maintaining a zero-balance account.

Secondly, a cost sharing model could be worked out between banks and various government agencies as the government is considering cash transfers of subsidies and welfare payments directly into the bank account of beneficiaries under the DBT scheme. Banks can levy a transaction fee in the range of 0.5 to 2 percent on the value of each payment made to the beneficiary's account.

Thirdly, the adoption of appropriate and affordable technology can bring down transaction costs over time. The introduction of low-cost smartphones provides a unique opportunity to deliver affordable banking services to poor people. The M-PESA in Kenya, GCash in Philippines and Celpay in Zambia are notable examples of providing a variety of financial services to low-income households in cheap and convenient ways.

Lastly, the total annual cost of the JDY estimated at Rs.150 billion is just one-tenth of total operating expenses of Rs.1566 billion incurred by banks in 2012-13. If the domestic banking system can spend Rs.1566 bn to provide banking services to 600 million people, can't it spend Rs.150 bn to serve another 600 million people? Many studies in India and elsewhere have proved beyond doubt that poor are bankable and trustworthy. If 50 percent of country's population joins the mainstream banking system, it can vastly improve the lives of the people in the base of the pyramid and contribute to inclusive economic growth.

If Rs.80 trillion Indian banking system can bear huge losses due to bad loans given to big corporate willful defaulters, can't it share the costs involved in providing affordable banking services (a public good) to millions of poor people?

Hence, the contentious issue is not the financial viability of JDY but its design and actual implementation.

No Silver Bullet to Financial Inclusion

More than four decades of experience tells us clearly that there is no single silver bullet approach towards FI given the sheer scale of financial exclusion in India. To ensure sustainable universal financial inclusion under the JDY, both supply-side and demand-side challenges have to be addressed simultaneously in a systematic manner.

The government should develop a holistic framework and infrastructure support focused on four core dimensions of financial inclusion – affordable products; reliable and viable delivery models; diverse customer needs; and multilingual financial education programs. The key to the success of the JDY will lie in the government's ability to address these challenges in a coordinated, coherent and collaborative manner with banks and other stakeholders.

It is widely known that financial inclusion is a means to an end and not an end in itself. Financial inclusion alone cannot lift millions of poor Indians out of poverty but the regular usage of banking products and services can provide them with an opportunity to overcome poverty and improve their lives. The real challenge is to encourage poor people to actively use a variety of formal banking services (including savings, credit and remittance) so that their dependence on informal sources is greatly reduced.

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